No. 13111

In the United States Court of Appeals for the Ninth Circuit

IDALIA O. FRATT, APPELLANT

v.

JOHN R. ROBINSON AND JANE DOE ROBINSON, HUSBAND AND WIFE, ET AL., APPELLEES

APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE WESTERN DISTRICT OF WASHINGTON, NORTHERN DIVISION

BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION, AMICUS CURIAE

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JURISDICTION

This is an appeal from a portion of an order entered on August 6, 1951, by United States District Judge J. Frank McLaughlin, sitting by assignment in the United States District Court for the Western District of Washington, Northern Division (Tr.[1] 42). In that portion Judge McLaughlin dismissed plaintiff's action for lack of jurisdiction of the subject matter (Tr. 40–41). This is discussed more fully in the Statement of the Case below.

Plaintiff based her action on defendants' alleged violation of Rule X–10B–5,[2] promulgated by the Se-

[1] Transcript of Record.

[2] 17 C. F. R. § 240.10b–5.

curities and Exchange Commission (hereinafter called the "Commission") pursuant to Section 10 (b) of the Securities Exchange Act of 1934[3] (frequently referred to as the "Act" or "1934 Act" hereinafter) (Tr. 4–6). Section 27 of the 1934 Act[4] vests the United States district courts with jurisdiction of such actions.

This Court has jurisdiction to review the order below under Section 27 of the 1934 Act, and Title 28, U. S. Code, § 1291.

STATEMENT OF THE CASE

1. Questions involved

The only question which appellant presents is the propriety of the ruling below dismissing her complaint, which charges defendants with a fraudulent purchase of her stock involving the use of the mails allegedly in violation of Rule X–10B–5, for the sole reason that the complaint failed to allege that the stock had been traded on a securities exchange or in the "over-the-counter" market by brokers or dealers.

Three other questions involving the proper interpretation of the Securities Exchange Act of 1934 were argued in the court below on defendants' motions to dismiss. Since it is probable that appellees will also present argument with respect to these questions in an effort to sustain the ruling below on alternative grounds if necessary, we shall also present in this brief the Commission's views on

[3] U. S. C. § 78j (b).

[4] 15 U. S. C. § 78aa.

the latter questions. Our argument with regard to these questions, under the circumstances, will be considerably less detailed. Should appellees' briefs warrant further comment on our part, we shall do so in a reply brief. The remaining three questions are as follows:

(1) Were the uses of the mails which defendants allegedly made, or caused to be made, in connection with their purchase of plaintiff's securities, particularly mailings to effect payment for the securities and to obtain delivery of them, sufficient to provide jurisdiction under Rule X–10B–5?

(2) Does a violation of Rule X–10B–5 entitle a person who has been injured thereby to maintain a civil action for private recovery?

(3) What statute of limitations is applicable to a private action seeking damages for the violation of Rule X–10B–5?

2. Pleadings below

The following is a summary of the complaint (Tr. 4–24):

Plaintiff (the appellant), an elderly widow, is the former owner of 781.25 shares of the common stock[5] of the Robinson Manufacturing Company (now known as the Robinson Plywood and Timber Company), a company incorporated and engaged in the lumber business in the State of Washington (Tr. 4, 7). The individual defendants (now appellees), with the exception of the Diffords and McGheis, were the majority stockholders,[6] who constituted a "control

[5] 7,500 shares were authorized and issued.

[6] They held 5,000 shares.

group" actively managing the defendant corporation as officers, directors and controlling stockholders (Tr. 7–8). Plaintiff and her husband had owned their shares since 1901 (Tr. 7). She is inexperienced in business matters and never participated in the business (Tr. 7). Her husband, however, who was deceased at the time of the transaction in question, had been active in the business. After his death, plaintiff's information concerning the business came from the defendant John R. Robinson, the company's president, and other members of the control group with whom her husband had maintained close personal and business relationships while he was alive. To a large extent it was because of these past relationships that plaintiff placed complete trust and confidence in these people (Tr. 8–9). Some time prior to September 1945, however, these trusted individuals conceived and initiated a scheme to defraud minority stockholders into selling their shares to them at grossly inadequate prices (Tr. 9–10). Pursuant to this scheme, the defendant John R. Robinson, by making numerous misrepresentations to plaintiff and concealing material facts concerning the financial and business condition of the company, conditioned her mind for selling her stock. Contrariwise to the true facts, the prospects described by Robinson were quite dismal (Tr. 11–14). Plaintiff and the other minority stockholders had no representation on the board of directors, and she was not aware of the falsity of Robinson's representations (Tr. 12–14). Thereafter, in September 1945, an agent of the control group—the defendant Samuel P. McGhei, who was an em-

ployee of the company—induced plaintiff to sell her stock ostensibly to him at $64 per share, for a total of $50,000 for the entire block, by misrepresenting that he was buying the stock for himself with his own money and that his purpose was to improve his chances for advancement in the company. Actually, McGhei bought for members of the control group, who furnished the purchase money and divided the stock thus acquired among themselves (Tr. 14–18).

Subsequently, in 1948, the control group, through another agent, the defendant W. E. Difford, further effectuated this scheme by inducing the other minority shareholders, likewise through fraudulent misrepresentations and concealment of material facts, to sell their shares to the control group at grossly inadequate prices. The other minority shareholders, however, were paid $320 per share (Tr. 10, 18–22). Thereafter, the control group caused the articles of incorporation to be amended so as to change the name of the company, and to increase the authorized number of shares from 7,500 of $100 par value each to 1,500,000 shares of $1 par value each, or an increase of 66 for one. Thereupon the control group caused a registration statement to be filed with the Commission offering 271,025 shares of this stock for sale to the public. Plaintiff alleged that at least 216,546 of these shares represented stock of the former minority shareholders (Tr. 22). The registration statement was withdrawn when former minority shareholders, other than the plaintiff, instituted a lawsuit against members of the control group and W. E. Difford (Tr. 23). That lawsuit, filed in 1949 (and referred to later in this

brief), was compromised in 1950 pursuant to an arrangement whereby the former minority shareholders who brought that action obtained an additional $110 per share, which brought their total receipts to $430 per share, or nearly seven times what plaintiff was paid (Tr. 10–11).

Plaintiff claims that her stock was worth $500 per share in 1945 at the time of the fraudulent purchase, and $1,000 per share in 1949 when she discovered the facts, so that its total worth at the later date was $781,250. Accordingly, she seeks $731,250 in damages (Tr. 23–24). She avers that she did not discover the true facts until after January 1949, and that she could not have discovered them in the exercise of due diligence prior to that time (Tr. 6). She charges that defendants used the mails and facilities of interstate commerce in effectuating their fraudulent scheme, and bases her action on defendants' alleged violation of the antifraud provisions of the Commission's Rule X–10B–5 under the Securities Exchange Act of 1934 (Tr. 4–6, 17–18).

Defendants moved to dismiss the complaint on the following grounds:

(1) The transactions charged "did not involve a security traded in upon a securities exchange or upon an 'over-the-counter' market" and, therefore, were not subject to the Securities Exchange Act of 1934, which was alleged to be the basis for the court's jurisdiction (Tr. 25–26, 29, 32).

(2) The complaint did not allege that the mails, instruments of interstate commerce, or facilities of any national securities exchange, were used in connec-

tion with the fraud or deception allegedly effected by defendants upon the plaintiff in acquiring her stock (Tr. 26, 32).

(3) There is no private civil right of action under the Securities Exchange Act of 1934 for the transactions alleged (Tr. 26, 29, 32).

(4) The action was barred by the statute of limitations (Tr. 26, 30, 32).

Defendant W. E. Difford also moved to dismiss the complaint on the general ground that no claim had been stated as to him (Tr. 29). Defendants McLeods moved to dismiss on the additional ground that the complaint "fails to sufficiently allege these defendants' participation in or control over the acts and conduct complained of" (Tr. 33).

Motions to strike various allegations of the complaint as irrelevant and immaterial to the issues involved were also filed (Tr. 26–28, 30–31, 34–35). In addition, defendants McLeods filed a motion for a more definite statement (Tr. 33).

3. The Commission as amicus curiae below

Apprised of the pendency of this lawsuit, which involves the proper construction of a statute primarily administered by the Commission, the Commission sought and obtained leave of court to file a brief limited to an expression of its views on the questions of statutory interpretation (Tr. 35–37, 45).

In its brief, the Commission emphasized that it made "no independent assertions with respect to the facts" (p. 2). The Commission expressed disagreement with the first three of defendants' contentions.

With respect to the fourth—that relating to the statute of limitations—it expressed the view that the matter was governed by the law of the state of the forum. It did not undertake to argue any controverted issue of state law. Moreover, it expressed no opinion on the additional grounds urged in the motions to dismiss filed by defendants Diffords and McLeods for the reason that they involved mixed questions of fact and law involving problems which were not peculiar to the 1934 Act.

4. The order below

Judge McLaughlin's decision was handed down from the bench on July 31, 1951, immediately following the oral argument. He announced that he would dismiss the action because he did not believe the 1934 Act was applicable to transactions in a security which had not been traded on an exchange or in the over-the-counter market by brokers or dealers. A formal order to this effect was entered on August 6, 1951 (Tr. 40–41). In the August 6th order, however, Judge McLaughlin denied defendants' motions to dismiss to the extent that they were based on contentions that the 1934 Act does not provide a private right of civil action for the violation of Rule X–10B–5, and that the statute of limitations had run. Defendants' contention with respect to the sufficiency of the mailings was not ruled upon. Certain portions of defendants' motions to strike were granted and others denied (Tr. 38–41).

The exact language of the portion of the order appealed from is as follows:

> It is Further Ordered, Adjudged and Decreed that the several motions of all the defendants to dismiss the action under Rule 12 (b) (1) of the Rules of Civil Procedure for lack of jurisdiction over the subject matter, it appearing on the face of the complaint that there is no diversity of citizenship between the parties and that the action does not involve a controversy under the Constitution and laws of the United States, be and the same is hereby granted upon the sole ground that the transactions complained of do not involve a security traded in or upon a securities exchange or upon an "over-the-counter" market and are therefore not within the purview of the Securities Exchange Act of 1934 which is set forth in the complaint as the basis of jurisdiction, and plaintiff's complaint and the cause or causes of action alleged therein are hereby dismissed with costs * * * (Tr. 40–41).

5. The appeal

On August 28, 1951, plaintiff filed a notice of appeal from the above-quoted portion of Judge McLaughlin's order (Tr. 42–43).

SPECIFICATION OF ERROR

The single error charged by appellant in her Statement of Points is the action of the district judge in dismissing the complaint on the ground that the transactions alleged did not fall within the purview of the Securities Exchange Act of 1934 because the security involved was one which had not been traded on an exchange or in the over-the-counter market by brokers or dealers (Tr. 47–48). The Commission also believes this was error.

STATUTE AND RULE INVOLVED

Section 10 (b) of the Securities Exchange Act of 1934, 15 U. S. C. § 78j (b), provides:

> It shall be unlawful for *any person,* directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
>
> * * * * *
>
> To use or employ, in connection with the purchase or sale of *any security registered on a national securities exchange or any security not so registered,* any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors. [Emphasis supplied.]

Rule X–10B–5 promulgated by the Commission thereunder, 17 CFR § 240.10b–5, provides:

> It shall be unlawful for *any person,* directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,
>
> (1) to employ any device, scheme, or artifice to defraud,
>
> (2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (3) to engage in any act, practice or course of business which operates or would

> operate as a fraud or deceit upon any person,
>
> in connection with the purchase or sale of *any security.* [Emphasis supplied.]

Where necessary, other statutory provisions are set forth in relevant part in the argument below.

SUMMARY OF ARGUMENT

I

The ruling below that Section 10 (b) of the 1934 Act is inapplicable to transactions in a security not traded on an exchange or by brokers or dealers in the over-the-counter market is contrary to the plain and unambiguous language of Section 10 (b) and to all other court rulings on the question. The ruling below is also vague and indefinite; for it provides no positive standard as to when the statute is applicable to non-exchange transactions in securities not registered for exchange trading. That Section 10 (b) is a catch-all anti-fraud provision applicable to *all* transactions in securities, provided that the mails or instruments of interstate commerce have been used, is made clear by the plain language of that section, the relevant terms of which are expressly defined in Section 3 of the Act. So read, Section 10 (b) fits understandably into a carefully planned statutory program. Narrowed in the manner adopted below, it becomes largely a meaningless duplication of other statutory provisions.

The limitation implied by the court below finds no warrant in the statute. Even if it be assumed *arguendo* that a statutory preamble may properly be

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referred to under the circumstances, the preamble language in Section 2, upon which defendants have relied, affords no basis for narrowing the remedial scope of Section 10 (b). If anything, it shows that the broad coverage of the statute was not unintentional; for Section 2 refers to "over-the-counter" transactions (which include transactions between non-professionals) and particularly, as here, to transactions by corporate officers, directors, and principal stockholders. The legislative history, upon which defendants have also relied, lends absolutely no support to the proffered limitation and has no relevancy herein. This again assumes *arguendo* that it is proper to refer to the legislative history in the absence of any ambiguity in the statute. The history relied upon by defendants deals exclusively with the original provisions of Section 15 (since repealed) authorizing the regulation of the special two-way markets in particular securities made or created by certain brokers or dealers. In contrast, the present Section 15 applies to all transactions of brokers or dealers. Its caption "Over-the-Counter Markets" is the same as that of the original Section 15 and is intended merely as a convenient reference guide to the only section of the Act which deals exclusively with over-the-counter transactions. Contrariwise to defendants' argument, Section 15 in the light of its caption does not circumscribe the scope of the "over-the-counter" markets subject to the Act—certainly not the scope of Section 10 (b), which contains no reference to this term. Actually, the portion of the over-the-counter market subject to the regulatory provisions of the present

Section 15 is much greater than that which defendants would subject to the catch-all anti-fraud provisions of Section 10 (b); for defendants would require *"regular trading"* in a *two-way* broker-dealer market in order to render applicable the protection of Section 10 (b).

Defendants' argument that the 1934 Act is a "criminal" statute which should be construed "strictly" is of no importance; for Section 10 (b) clearly applies to the transaction alleged whether the section be given a "liberal" or "strict" construction. The failure of the Commission to promulgate Rule X–10B–5 until 1942 provides no indication of Commission disbelief in its power to promulgate the Rule, as defendants have argued. More important, that delay is in any event irrelevant herein for the Rule does not go beyond Section 10 (b) itself as respects the matter in controversy. The dispute relates basically to the construction of the statute itself.

The construction of the Act proffered by the defendants and adopted by the court below has untoward results when applied to many other provisions of the statute as well as to Section 10 (b). In addition to being erroneous, it is also impractical; for, under it the protection of the Act will depend to a substantial degree upon fortuitous circumstances which have no relevancy to the statutory purpose, and which may often be difficult, if not impossible, to establish.

II

The mailings alleged in the complaint are adequate to provide jurisdiction. Under Section 10 (b) and

Rule X–10B–5 it is not necessary that the mails be used to communicate the misrepresentations or statements of half-truths complained of. It is sufficient simply that the mails are used in connection with the fraudulent purchase or sale. Accordingly, the alleged uses of the mails to effect payment for, and to obtain delivery of, appellant's stock are sufficient under the many cases construing Rule X–10B–5 and the similar jurisdictional language of Section 17 (a) of the Securities Act of 1933, upon which the Rule was patterned. The decision in *Kemper* v. *Lohnes,* 173 F. 2d 44 (C. A. 7, 1949), relied upon by defendants below, involved the differently phrased jurisdictional language of Section 12 (2) of the Securities Act of 1933, with respect to which courts are divided. The courts are agreed, however, on the above stated construction of Rule X–10B–5 and Section 17 (a) of the Securities Act of 1933.

III

The courts are also in unanimous agreement with the ruling below that a private civil action may be maintained for the violation of Rule X–10B–5 even though the statute does not expressly provide for such an action. The implied right of action has been predicated (1) upon the basic principle of tort law which permits a person who has been injured by another's violation of a statute intended for his protection to sue for private relief, and (2) upon the provisions of Section 29 (b) of the 1934 Act which render void, as respects the rights of the violator, any contract made in violation of the statute, and which contain other indications that Congress assumed that

private actions could be maintained for the violation of many of the provisions of the statute which do not expressly authorize private recovery.

IV

The applicable statute of limitations for a Rule X–10B–5 action for damages is that of the state of the forum—here, Washington. This is because no federal statute of limitations has been prescribed for such an action, and the federal rule in such a case requires a reference to that local statute. We claim no expertise on the state law and, accordingly, express no opinion as to whether the court below properly rejected defendants' contention that the action was barred.

ARGUMENT

I

Section 10 (b) of the Securities Exchange Act of 1934, and Rule X–10B–5 thereunder, apply to all securities transactions involving the use of the mails or instruments of interstate commerce, whether or not the transaction involves a security traded upon an exchange or in the "over-the-counter" market of securities brokers or dealers

1. The Ruling of the District Court

Judge McLaughlin did not rule that Congress could not outlaw fraudulent transactions in securities which are not professionally traded on exchanges or over-the-counter by brokers and dealers, where the mails or facilities of interstate commerce are involved. He ruled that Congress had not, in fact, done so. This is the first time any court has taken this narrow view of the 1934 Act. This, however, is not the first case in which such a narrow view of the federal statute

was urged by defendants charged with fraudulent securities transactions. As we show below, all the other court decisions are adverse to defendants-appellees. This is also the first appellate court test of this narrow view of the 1934 Act. It is somewhat odd that it has arisen in the context of an appeal from the only court ruling upholding that view.

We regard it as unfortunate that Judge McLaughlin did not write an opinion to support his disagreement with all the other district judges who have ruled on the point. Needless to say, it would have been helpful to this Court in evaluating his ruling, and to the parties and the Commission in briefing the appeal from that ruling. Judge McLaughlin's order states simply that the transaction was not "within the purview of the Securities Exchange Act of 1934" because it did "not involve a security traded in or upon a securities exchange or upon an 'over-the-counter' market" (Tr. 41). There is no indication of what type of trading in the "over-the-counter" market the court below would consider sufficient to provide jurisdiction. More specifically, would the court require that specific brokers or dealers have "made a market" in the security—that they have regularly published "bid" or "asked" quotations, or both, for the particular security? Defendants' district court briefs quoted descriptions of that particular type of broker-dealer activity as descriptions of the "over-the-counter" markets. If this is what the court had in mind, would it require a one-way or two-way market—*i. e.,* "bids" only or "asked" only, or both? Moreover, would it be sufficient that such a market had been

made at some time in the past, or would it be necessary to show that such a market was being made at the time of the transaction complained of? Again, would the market have to be made in the same locality as that in which the transaction complained of took place, or would it suffice that somewhere, no matter how distantly located, a broker or dealer had made or was making a market in the particular security? Or would the court below be satisfied by proof of the fortuitous circumstance that at some time and place, no matter when or where, the particular security had been the subject of a transaction involving a broker or dealer?

None of these problems is presented by Section 10 (b) itself, which, we believe, is applicable to *all* fraudulent securities transactions involving the use of the mails or facilities of interstate commerce irrespective of whether the security has been or is being professionally traded by brokers or dealers. They arise only when the plain language of the statute is held to mean something else. Exactly what else has not yet been made clear either by the defendants or by the court below. The only thing which is clear is that these defendants, like the others, are anxious to avoid the federal statute.

2. The Rulings of Other Courts

Three other courts have rejected the proffered limitation of Section 10 (b) and the 1934 Act; and, in another case, a closely similar, if not essentially the same, contention was also rejected. As we have stated, the ruling below is the only one which approves the suggested narrowing of the Act.

In the earlier lawsuit referred to in the complaint, brought by the other former minority shareholders against members of the control group and W. E. Difford, the United States District Court for the Eastern District of Pennsylvania rejected the very same contention of these defendants. *Robinson* v. *Difford,* 92 F. Supp. 145 (1950). As distinguished from the ruling below, the decision in the Pennsylvania case was not handed down from the bench without opinion. Five months after the oral argument, and after study of several main and reply briefs, some of which were filed after the oral argument, the court issued its opinion. Defendants took no appeal, but, as indicated in the instant complaint, elected to make a substantial settlement. In the *Robinson* case, Judge Grim emphasized that Section 10 (b), in plain and unambiguous language, applies to transactions in any security, whether or not registered on an exchange, and whether or not the security was ever traded by brokers or dealers in the "over-the-counter" market. "This," he said, "is so clear from the language of Section 10 (b) itself that no other proper interpretation is possible" (92 F. Supp., at 148). Accordingly, he refused to consider defendants' argument (which we shall discuss below) based on the preamble language of Section 2 and a selection of excerpts from the legislative history of the Act. The preamble, he said, could in no event be relied upon "to alter the plain and unambiguous provisions of Section 10 (b)," and the legislative history, likewise, need not be referred to where the statute is clear (*ibid.*). Judge Grim also considered the other operative pro-

visions of the Act and concluded that none of them gave any support to defendants' suggested limitation (*id.,* at 148–149).

More recently, the same contention was rejected by the United States District Court for the District of Delaware in *Speed* v. *Transamerica Corp.,* 99 F. Supp. 808 (1951). In that case, former minority stockholders sued the majority stockholder for failing to disclose material inside information in purchasing their shares—information which would have shown that the stock was worth several times more than plaintiffs were paid. The narrow construction of the Act, adopted by the court below in the instant case, was urged *inter alia* by way of defense. As in the instant case, the defendant relied upon the preamble language of Section 2 and the same collection of excerpts from the legislative history. Chief Judge Leahy concluded that there was no merit in the proffered construction. In so doing, he gave special attention to the definitions in Section 3 of the various terms used in Section 10 (b). He, too, found Section 10 (b) to be plain and unambiguous. We refer the Court to his excellent analysis reported in 99 F. Supp., at 830–831.

The contention was also made and rejected by the United District Court for the District of Columbia in *Grand Lodge of International Association of Machinists* v. *Highfield,* Civ. No. 3661–48. The complaint charged officers and directors with fraud in the purchase of the shares of the principal stockholder, a labor union. Defendants moved to dismiss the Rule X–10B–5 count on the ground that the stock

was not registered on any exchange and had not been traded in the brokers-dealers' over-the-counter market.[7] On January 24, 1949, Judge Letts entered an order denying the motion to dismiss. There was no opinion.[8]

A closely similar, or perhaps essentially the same, contention—namely, that Section 10 (b) has no application to transactions in the stock of a closely held corporation—was also rejected in *Kardon* v. *National Gypsum Co.*, 69 F. Supp. 512 (E. D. Pa. 1946). The complaint alleged that, in violation of Rule X–10B–5, the defendants, two shareholders and directors of a

[7] Paragraph 5 of the "Opposition of Defendants to Plaintiff's Motion for Leave to Amend" in the *Grand Lodge* case, which was incorporated by reference into defendants' Motion to Dismiss the third count of the amended complaint (alleging violation of Rule X–10B–5), stated:

"The defendants are not, and were not brokers, dealers in securities, or otherwise subject to the jurisdiction of the Securities and Exchange Commission with respect to the matters referred to in the complaint."

Defendants' supporting "Memorandum of Points and Authorities" in that case argued (pp. 1–2):

"It is significant that no authorities are cited in support of plaintiff's position that the transaction referred to in the original complaint is within the purview of the Securities and Exchange Act. As a matter of fact, we submit that the Act itself clearly indicates that it has no application to this case. Section 2 recites:

[Section 2 is quoted]

*   *   *   *   *

"Furthermore, *it is not alleged that the stock purchased by these defendants was listed on any exchange or traded in over-the-counter*. The fact is, it was not so listed, and so far as these defendants are aware, was not traded in an 'over-the-counter market'. * * *" [Emphasis ours.]

[8] See 59 Yale L. J. 1120, 1140, n. 95 (1950). This case was also settled before trial.

corporation possessing only four shareholders, had induced the plaintiffs, the other two shareholders and directors, to sell their shares to them by fraud, including nondisclosure of material corporate information. There was no stock exchange trading in the stock and no allegation that it had ever been dealt in by brokers or dealers. It was held that the complaint stated a cause of action. Defendants had denied the applicability of Section 10(b) because (1) the stock was never listed on any exchange or traded in the "over-the-counter market," and (2) the sellers were not "investors" intended to be protected by the statute.[9] The court, in denying the motion to dismiss, stated:

> * * * *the whole statute discloses a broad purpose to regulate securities transactions of all kinds,* and as part of such regulation, *the specific section in question provides for the elimination of all manipulative or deceptive*

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[9] The footnote observation in *Robinson* v. *Difford* (92 F. Supp., at 149, n. 6) that the first question was not raised in the *Kardon* case is incorrect. Thus the brief of the defendants Slavins in the *Kardon* case argued (p. 11):

"Only four persons, the two plaintiffs and the two defendants are involved in the purchase and sale of the securities in question, i. e., the common stock of the two Michigan corporations, *which was never listed on any Exchange, nor traded in the Over-the-Counter market.* Between them, the four owned all of the outstanding capital stock of the two corporations. There is no outside interest in any of the securities of the two Michigan corporations; there is, therefore, no public interest, since the two Kardons and the two Slavins hold all of the outstanding stock to the exclusion of the public. Nor are there any investors whose interest requires protection. *The plaintiffs cannot claim to belong to the investing public* insofar as these two corporations are concerned." [Emphasis ours.]

> *methods in such transactions.* * * * I cannot agree * * * that "investors" [as used in Section 10 (b)] is limited to persons who are about to invest in a security or that two men who have acquired ownership of the stock of a corporation are not investors merely because they own one-half of the total issue (69 F. Supp., at 514, emphasis supplied).

In a second opinion in the *Kardon* case, 73 F. Supp. 798 (1947), following a trial on the merits, in granting the relief sought by plaintiffs on the basis of findings upholding the allegations of the complaint, Chief Judge Kirkpatrick further observed:

> The acts of the defendants specified in the complaint constituted a violation of the Act. *Section 10(b)* makes it unlawful to use any deceptive device, in contravention of the Commission's rules, in connection with the purchase of *any security registered or unregistered. Rule X–10B–5* specifically makes it unlawful to "employ any device * * * to defraud * * * to omit to state a material fact necessary to make the statements made * * * not misleading or to engage in any act, practice or course of business which * * * would operate as a fraud or deceit * * *." Under any reasonably liberal construction these provisions apply to directors and officers who, in purchasing the stock of the corporation from others, fail to disclose a fact coming to their knowledge by reason of their position, which would materially affect the judgment of the other party to the transaction (73 F. Supp., at 800). [Emphasis supplied.]

Slavin v. *Germantown Fire Insurance Co.,* 174 F. 2d 799 (C. A. 3, 1949), is also worthy of mention. The stock in that case was part of a new issue being offered first to policy holders of an insurance company which was being converted from a mutual to a stock company. It was not traded on an exchange and there is no indication that any broker-dealer "over-the-counter" market had been developed at the time of the transactions in question. A majority of the court of appeals directed dismissal of the action only because it felt that whatever fraud may have been involved was vitiated by defendant's "last minute" disclosure. It seems clear from the opinion that plaintiffs would have recovered absent this disclosure.[10]

We also call attention, in passing, to the decisions under the almost identical language of Section 17 (a) of the Securities Act of 1933 (hereinafter sometimes called the "1933 Act"), 15 U. S. C. § 77q (a). In *Rosenberg* v. *Globe Aircraft Corp.,* 80 F. Supp. 123, 124 (E. D. Pa. 1948), the court, speaking of the 1933 and 1934 Acts, stated that "The two acts are unquestionably in pari materia and must be construed together to make a consistent whole," and that accordingly the court should look "at them as one statute." The antifraud provisions of Section 17

[10] See also *Birnbaum* v. *Newport Steel Corp.*, 98 F. Supp. 506, 508 (S. D. N. Y. 1951), in which the court stated: "The Rule was designed to fill a void that had long existed in the Securities and Exchange Commission's control over fraudulent dealing in securities, i. e., the absence of any prohibition against fraud practiced on purchasers or sellers of securities by persons who were not brokers or dealers."

(a), it appears, have repeatedly been held applicable to sales of securities which were not traded on an exchange or by securities brokers or dealers. See, *e. g., S. E. C.* v. *C. M. Joiner Leasing Corp.,* 320 U. S. 344 (1943); *U. S.* v. *Earnhardt,* 153 F. 2d 472 (C. A. 7, 1946), *cert. denied,* 328 U. S. 858 (1946); *U. S.* v. *Carruthers,* 152 F. 2d 512 (C. A. 7, 1945), *cert. denied,* 327 U. S. 787 (1946); *Bowen* v. *U. S.,* 153 F. 2d 747 (C. A. 8, 1946), *cert. denied,* 328 U. S. 835 (1946); *U. S.* v. *Monjar,* 147 F. 2d 916 (C. A. 3, 1944), *cert. denied,* 325 U. S. 859 (1945).

3. Summary analysis of the statute

It will be observed that Section 10 (b), by its very terms, is designed to give the Commission rule-making powers with respect to fraud in the purchase or sale of securities virtually as broad as the reach of the federal power, and that Rule X–10B–5 fully exercises that power with respect to purchases or sales of any security. The antifraud provisions of Section 15 (c) (1), 15 U. S. C. § 78o (c) (1), are applicable only to nonexchange transactions by brokers or dealers. Section 10, however, expressly applies to transactions by "any person." The term "person," it should be noted, is defined broadly by Section 3 (a) (9), 15 U. S. C. § 78c (a) (9), to include any individual and various types of business organizations, as distinct from more limited definitions of the terms "broker" and "dealer" in Section 3 (a) (4) and 3 (a) (5), 15 U. S. C. §§ 78c (a) (4) and 78c (a) (5). While paragraph (a) of Section 10 deals only with short sales or stop-loss orders on

the exchanges, paragraph (b) applies to fraudulent activities in the purchase or sale of "any security registered on an exchange or any security not so registered."[11] It is difficult to see what more sweeping language could have been found. Section 3 (a) (12), 15 U. S. C. § 78c (a) (12), which specifies the types of securities which are exempted or which may be exempted by the Commission from certain regulatory provisions of the Act, contains no exemption of the type suggested by the defendants. Moreover, *no securities whatever are exempted from the antifraud provisions of Section 10 (b)*. It should also be noted that the term "security" is broadly defined in

[11] Use of the quoted language rather than the briefer phrase "any security" was intended to buttress the provisions of Section 33, 15 U. S. C. § 78gg, in the event of an attack on constitutional grounds. Section 33 provides that should "the application of [any] provision [of the Act] to any person or circumstances * * * be held invalid * * * the application of such provision to persons or circumstances other than those as to which it is held invalid shall not be affected thereby." Thus, if for any reason Section 10 (b) were held unconstitutional as respects its application to "any security not so registered," its applicability to "any security registered on a national securities exchange" would not be affected thereby. It is evident from the use of the briefer phrase "any security" in Rule X–10B–5 in place of the quoted statutory language that the Commission itself never had any doubt as to the intended broad scope of Section 10 (b). An agency's construction of a statute which it administers is, of course, entitled to considerable weight. *S. E. C.* v. *Associated Gas & Electric Co.*, 99 F. 2d 795, 797 (C. A. 2, 1938); *Roland Co.* v. *Walling*, 326 U. S. 657, 676 (1946); *U. S.* v. *American Trucking Assns.*, 310 U. S. 534, 549 (1940). The validity of Section 10 (b) is not an issue in the instant case. The section and rule were held constitutional in *Speed* v. *Transamerica Corp.*, 99 F. Supp. 808, 831–832 (D. Del. 1951). See also *Fischman* v. *Raytheon Mfg. Co.*, 188 F. 2d 783, 786 (C. A. 2, 1951).

who may have been swindled by a person other than a broker or dealer, and who thus may have no right of recovery under either Section 9 (a) or Section 15 (c) (1), is entitled to sue for the violation of Section 10 (b).

Violations of the antifraud provisions may be enjoined at the instance of the Commission, or, in the case of wilful violations, may be criminally prosecuted by the Department of Justice on the Commis-

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against fraudulent or deceptive securities transactions might be helpful to the Court at this point. Fraud or deception in certain types of transactions was deemed by Congress to require special treatment, and many of the provisions of the 1934 Act and the 1933 Act reflect that program. Thus, as we have already indicated, Section 9 of the 1934 Act, 15 U. S. C. § 78i, deals with fraud in the context of manipulative transactions in securities registered for trading upon an exchange; whereas Section 15 (c), 15 U. S. C. § 78o (c), is limited in coverage to fraudulent and deceptive transactions by securities brokers and dealers not effected upon an exchange. Similarly, Section 18 of the 1934 Act, 15 U. S. C. § 78r, deals only with liability for misleading statements in applications, reports, and documents filed under that statute. In the 1933 Act, Section 11, 15 U. S. C. § 77k, pertains to liability arising from false registration statements; Section 12 (2), 15 U. S. C. § 77*l* (2), deals with liability resulting from misrepresentations or statements of half-truths in prospectuses or oral communications; and Section 17 (b), 15 U. S. C. § 77q (b), is directed against certain types of touting. In addition, Section 24 of the 1933 Act, 15 U. S. C. § 77x, and Section 32 of the 1934 Act, 15 U. S. C. § 78ff, provide penalties for wilful violations of these statutes and for wilfully false or misleading statements in documents required to be filed with the Commission. Each statute, however, has a broad general antifraud provision *in addition* to such provisions of relatively narrow scope. In the 1933 Act that broad provision is Section 17 (a), 15 U. S. C. § 77q (a). Section 17 (a), however, covers only fraud in the *sale* of a security. The 1934 Act provision, Section 10 (b), is even broader, for it applies to fraud in the *purchase* as well as in the sale of a security. While Congress has not under-

sion's recommendation. The Commission's personnel and funds, however, are quite limited. It cannot even attempt to nip every fraud in the bud, or to investigate fully every possible violation from the standpoint of potential criminal prosecution. Its efforts must necessarily be expended where they are likely to do the most public good. In many cases where the Commission has taken no court action, however, the federal securities statutes have been privately en-

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taken in connection with the *purchase* of securities to parallel the registration requirements of the 1933 Act applicable, with certain exceptions, to the sale of securities through a public offering, there is, of course, no more reason for not affording a broad federal remedy for fraud in connection with the purchase of securities than in connection with their sale. As we have said, Section 10 (b), as implemented by Rule X–10B–5, reflects the intention to make the remedy for fraud in the securities field practically as broad as the reach of the federal power in respect of interstate commerce and the mails. Except for its coverage of purchases as well as sales, the language of Rule X–10B–5 is essentially the same as that of Section 17 (a) of the 1933 Act upon which it was patterned.

As we have already indicated, the catch-all nature of these general antifraud provisions in each statute is further illustrated by the fact that exemptions from various regulatory sections, which are available with respect to certain types of securities and certain types of transactions in securities, are *not* available under these antifraud provisions. With regard to the 1934 Act, see p. 25, *supra*. In the 1933 Act the antifraud provisions of Section 17 (a) apply to securities *transactions* exempted from various regulatory provisions, *e. g.*, nonpublic offerings which are exempted from the registration requirements of the 1933 Act [Section 4 (1), 15 U. S. C. § 77d (1)], as well as to classes of *securities* similarly exempted from various regulatory provisions [see Sections 3, 17 (c), 15 U. S. C. §§ 77c, 77q (c)]. When Congress desired to delineate the persons, transactions, or securities covered or excluded from the coverage of a particular provision, it appears that it knew exactly how to do so.

forced through actions for damages or other relief by persons who have been victimized. While in most situations involving violations of Rule X-10B-5 a defrauded person can bring an action in the state court for common-law fraud and deceit, an action in the federal court for the violation of the rule has distinct advantages from the standpoint of the plaintiff.[13] To aid the courts on questions involving the proper interpretation of the federal securities statutes, the Commission frequently participates as *amicus curiae,* as it has in the instant case.

4. Evaluation of the various arguments submitted in support of the construction proffered by defendants and adopted by the court below

Appellees' briefs have not yet been filed. We do have copies of the briefs they filed as defendants in the court below, however, and we assume that they will make substantially the same arguments in this appeal. Our brief in the proceedings below likewise was filed before those of the defendants, and was based on the arguments unsuccessfully made by these defendants in the *Robinson* v. *Difford* case. Defendants' briefs in the court below, taken as a whole, strike us as a somewhat improved version of the argument presented in the earlier case. We did not receive copies of these briefs until after Judge McLaughlin handed down his ruling, and this is our first opportunity to evaluate defendants' argument as suc-

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[13] For an excellent discussion of this particular point, see Comment, *The Prospects for Rule X-10B-5: An Emerging Remedy for Defrauded Investors*, 59 Yale L. J. 1120, at 1123-1126, 1130-1133 (1950). See also pp. 59-60, *infra*.

For a general discussion of fraud concepts under the SEC statutes, see Loss, *Securities Regulation* (1951), c. XI.

cessfully presented below. Since Judge McLaughlin filed no opinion, we cannot tell how much of this argument he approved and how much he disapproved, if any. But it seems reasonable to assume that he went along with defendants' basic rationale.

We believe that we have shown that Section 10 (b) on its face is plain and unambiguous; and, given that plain meaning, it fits well into a carefully planned statutory program. Defendants' problem is, therefore, to convince this Court that Section 10 (b) should not be read literally, but should be watered down by implied limitations. The source of such implied limitations, they say, is the statutory preamble in Section 2, 15 U. S. C. § 78b. The preamble, they contend (although nowhere does it say so), indicates that Congress did not contemplate legislating with respect to transactions in securities which have not been traded on an exchange or by brokers or dealers in the over-the-counter market. To bolster this argument they submitted a number of quotations from the legislative history of the Act—quotations which we show below have no relevancy to the instant question, but which, defendants contended, support their narrow view of the statute. They have also made some other arguments of subordinate character, and we shall take up each of them; but the statutory preamble and the selected excerpts from the legislative history apparently constitute their basic stock in trade.

In the *Robinson* v. *'Difford* case Judge Grim was on firm ground when he refused to enter into the controversy as to the proper meaning of the preamble

section for the reason that "reliance on the preamble statement of section 2 in order to alter the plain and unambiguous provisions of section 10 (b) would violate a basic canon of statutory construction that statements in a preamble may be referred to only for the purpose of clarifying an ambiguity in a statutory provision" (92 F. Supp., at 148), citing *Yazoo & Mississippi Valley R. R.* v. *Thomas,* 132 U. S. 174, 188 (1889); *Coosaw Mining Co.* v. *South Carolina,* 144 U. S. 550, 563 (1892); *Fleming* v. *Hawkeye Pearl Button Co.,* 113 F. 2d 52, 56 (C. A. 8, 1940); Sutherland, *Statutes and Statutory Construction* (3d ed.), § 4820; Crawford, *Statutory Construction* (1940), § 205. This canon of construction gives recognition to the fact that a preamble statement is necessarily generalized in character and cannot deal with all the problems covered by a comprehensive statute. Accordingly, a preamble is not intended to provide the basis for changing the plain meaning of a specific statutory provision. In the court below defendants argued that Judge Grim improperly confined himself to Section 10 (b); and they supplied quotations from various authorities to the effect that a statute must be construed as a harmonious whole.[14] The fact is, however, that Judge Grim did consider the various operative provisions of the Act in reaching his ultimate conclusion. He expressly found that "there are no other sections of the Act which indicate that Congress intended to limit the application of the Act to transactions involving either registered securities or unregistered securities traded in the over-the-counter

[14] Brief of defendants John R. Robinson et al., pp. 30 *et seq.*

market" by brokers or dealers (92 F. Supp., at 148–149). In brief, Judge Grim's decision, in light of the authorities quoted by the defendants themselves, is a model of proper statutory construction. In rejecting the same narrow construction proffered in the *Speed* case, Chief Judge Leahy likewise considered other relevant provisions of the Act and concluded that there was no basis for implying limitations into the unambiguous provisions of Section 10 (b) (99 F. Supp., at 830–831). While we mention the foregoing canons of statutory construction, we do not rest upon them in this brief; for we do not believe that the preamble in Section 2 shows a congressional purpose to limit the scope of Section 10 (b), as defendants contend. Accordingly, we shall discuss Section 2 below.

Judge Grim's refusal to go into the legislative history of the Act likewise was proper under the circumstances. He had already found that the statute was unambiguous. Accordingly, he applied another basic canon of construction—that "the legislative history of an act may not properly be considered in construing an unambiguous statutory provision such as section 10 (b)" (92 F. Supp., at 148), citing *Ex parte Collet,* 337 U. S. 55, 61 (1949); *Wilbur* v. *U. S.,* 284 U. S. 231, 237 (1931); *U. S.* v. *Missouri Pacific Ry.,* 278 U. S. 269, 277 (1929); *Railroad Commission of Wisconsin* v. *Chicago, B. & Q. Ry.,* 257 U. S. 563, 588–589 (1922). In the court below, the defendants argued that the cited decisions of the Supreme Court should be considered in light of what they claim to be the present policy of the Supreme Court and other

the activities of brokers and dealers in the over-the-counter market had to await further study and later amendments. Thus, in the *original* Section 15 of the Act, Congress confined itself to delegating to the Commission the authority to promulgate appropriate regulations with respect to a small portion of the over-the-counter markets—namely, the two-way markets in particular securities maintained by certain brokers or dealers, or both, which, in a limited way, were comparable to the exchange markets. We shall have more to say about the original Section 15 later. As in the 1933 Act, Congress also inserted a catch-all antifraud provision in the 1934 Act—namely, Section 10 (b). Here, too, authority was delegated to the Commission to work out the details.

As already mentioned, the major battle concerned the regulation of the securities industry. The draftsmen of the Act anticipated a court test of the constitutionality of such regulation, particularly as respects the applicability of the "commerce clause." The strict-constructionism of the Supreme Court of the mid-thirties was a factor to be kept in mind. Accordingly, various provisions of the Act were drafted in terms of their applicability to specified persons or specified transactions, and a general separability provision was inserted in Section 33. In Section 2, Congress, in effect, presented a brief in support of the over-all constitutionality of the regulation provided.[17]

[17] Any doubt that this was the purpose of Section 2 can readily be eliminated by a perusal of the congressional hearings: see, *e. g.*, *Stock Exchange Regulation, Hearing Before the Committee on Interstate and Foreign Commerce*, H. R., 73d Cong., 2d Sess., on H. R. 7852 and H. R. 8720, pp. 28, 153, 518 (1934).

Necessarily, Congress spoke in ultimate conclusions of fact. It could not and did not attempt to set forth the evidence which persuaded it to enact each of the operative provisions of this statute. Certainly, it did not contemplate that its generalized findings, which omitted reference to many specific problems treated in the Act, would be used as the basis for narrowing the scope of provisions which had been drafted with considerable care.

There is no need to set forth Section 2 *in toto.* The language upon which defendants have relied is in the opening paragraph, which reads as follows:

> For the reasons hereinafter enumerated, *transactions in securities as commonly conducted upon securities exchanges and over-the-counter markets* are affected with a national public interest which makes it necessary to provide for regulation and control of such transactions and of practices and matters related thereto, including transactions by officers, directors, and principal security holders, to require appropriate reports, and to impose requirements necessary to make such regulation and control reasonably complete and effective, in order to protect interstate commerce, the national credit, the Federal taxing power, to protect and make more effective the national banking system and Federal Reserve System, and to insure the maintenance of fair and honest markets in such transactions: [Emphasis supplied.]

Following this paragraph is a series of congressional findings with respect to the interstate character of the activities regulated, existing practices with respect

to the use of the mails and instrumentalities of interstate commerce, the effect of these activities upon the national economy, the public interest to be served by federal regulation, and so forth.

Section 2 does not, in specific terms, refer to the catch-all antifraud provisions of the statute. It does refer, however, to the need for federal "regulation and control" of transactions in the "over-the-counter markets" as well as on the exchanges. An over-the-counter transaction is simply one which takes place off an exchange, and includes securities transactions between nonprofessional traders. Assuming *arguendo* the significance which defendants ascribe to a preamble statement in ascertaining the scope of a statute, one would think that this reference in Section 2 would suffice to dispel any doubts as to the intended broad coverage of the 1934 Act. Defendants, however, have seized upon this reference as a basis for arguing just the contrary. They contend that an "over-the-counter" transaction is one necessarily involving a professional securities broker or dealer, and that the term has no application to transactions between nonprofessionals. Thus, they argue, Section 2 shows that Congress intended to regulate and control only transactions on exchanges and the nonexchange transactions in which brokers or dealers are involved, and that this limitation on the coverage of the statute should be read into ever operative provision, irrespective of the literal language employed in a particular provision. There is also an added refinement to their argument. In the court below they were agreeable

to applying the statute to transactions between nonprofessionals provided that the security involved was registered for trading on an exchange or was "regularly traded" in the broker-dealer over-the-counter market. Such transactions, they explained, are "related to" trading in the organized markets and, as such, are within the intended scope of the Act.[18] Nowhere did they cite any authority for the proposition that an "over-the-counter" transaction must necessarily involve a professional broker or dealer,[19] nor did they explain what they meant by "regularly traded 'over-the-counter.'" In the latter regard they did quote with approval descriptions of the activities of brokers or dealers in "making or maintaining" two-way markets in particular securities.[20] In the absence of other explanation, we can only assume that this is the type of "regular trading" in a security which defendants would require as a condition to affording the protection of the statute to investors victimized by nonprofessionals.

Defendants' basic argument that the term "over-the-counter" market relates only to the nonexchange trading of professional brokers and dealers is lacking

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[18] Brief of defendants John R. Robinson et al., p. 11.

[19] As in the briefs of defendants in other cases, the defendants below relied upon quotations from various sources referring to or describing the activities of brokers and dealers in the systematized over-the-counter markets. Their rationale appears to be that, since the quoted discussions of the over-the-counter markets are confined to problems relating to the activities of professional traders, it should be assumed by implication that the term "over-the-counter" does not, in any case, include the trading of nonprofessionals. The fallacy of such reasoning is self-evident.

[20] Brief of defendants John R. Robinson et al., pp. 13–14, 16.

in merit.[21] The fact that Section 3 (a) (1), 15 U. S. C. § 78c (a) (1), contains a *specific definition* of the term *"exchange,"* whereas the statute *nowhere defines* the term *"over-the-counter market,"* is consistent with the general understanding that an over-the-counter transaction is simply one which does not utilize the facilities of a securities exchange. Confronted in the *Speed* case with the same contention as that proffered by the defendants below, Chief Judge Leahy held (99 F. Supp., at 830):

> An over-the-counter transaction is simply one which does not utilize the facilities of a securities exchange, but under the unambiguous provisions of the Act it covers the sale or purchase of a security on a doorstep as well as the trading of a professional securities broker. It would appear that over-the-counter transactions, as such, are not specifically regulated by the Act, but they are dealt with through provi-

[21] We recognize that a footnote to the *Robinson* v. *Difford* opinion speaks of "securities traded in the over-the-counter market" as "those securities not registered on a national exchange which are traded through a securities broker or with a securities dealer" (92 F. Supp., at 148, n. 3). The court, nevertheless, rejected defendants' ultimate contention as to the limited meaning of Section 10 (b). The court cited no authority for its view of an "over-the-counter" transaction. It is interesting to observe that the quoted footnote literally excludes a nonexchange transaction in an exchange-registered security from the purview of an "over-the-counter" market—something to which even the defendants would take exception. For reasons which we set forth in the text, we believe that this footnote statement improperly narrows the concept of the over-the-counter market. It is also interesting to observe that the footnote is inconsistent with the view we assume the instant appellees will take—that a two-way market in the particular security must be regularly maintained by a broker or dealer.

> sions directed at the trading activity of "any person" in "any security". In short, Congress did not intend to limit application of the Act to transactions on exchanges and in the organized over-the-counter markets maintained by brokers and dealers.[22]

In dealing with a similar contention in the *Kardon* case as to the scope of the statute, Chief Judge Kirkpatrick observed (69 F. Supp., at 514):

> * * * the whole statute discloses a broad purpose to regulate securities transactions of all kinds, and, as part of such regulation, the specific section in question [Section 10 (b)]

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[22] See also the following statements quoted by Chief Judge Leahy (99 F. Supp., at 830, n. 11):

"*Under the Securities Exchange Act of 1934, the over-the-counter markets are deemed to include all transactions in securities which take place otherwise than upon a national securities exchange.* These markets are immense, the activities embraced therein are varied, and they are of the utmost importance to the national economy." [Emphasis ours.] H. R. Rep. No. 2307, 75th Cong., 3d Sess. (1938), p. 2; Sen. Rep. No. 1455, 75th Cong., 3d Sess. (1938), p. 2.

"First of all, what is meant by the over-the-counter market? Briefly, this market embraces all transactions in securities not made on stock exchanges." Wallace R. Fulton, Executive Director of the National Association of Securities Dealers, Inc., in *Fundamentals of Investment Banking*, Sec. 8, p. 42 (Investment Bankers Association of America, 1947).

To the same effect is Friend, *Activity on the Over-the-Counter Markets* (U. of Pa. Press, 1951), p. 5:

"The over-the-counter markets are broader and more diverse than the exchange markets. Generally speaking, they encompass all transactions in securities not effected on exchanges."

See also the definition of "over-the-counter market" in Munn, *Encyclopedia of Banking and Finance* (1937), p. 545, as "the market for securities not listed on any regularly organized exchange." For a general discussion of the over-the-counter market, see Loss, *Securities Regulation* (1951), pp. 709–715.

provides for the elimination of all manipulative or deceptive methods in such transactions.

As indicated in the quoted portion of the *Speed* opinion, the term "over-the-counter" is not used in the operative provisions of the statute, but over-the-counter transactions are dealt with through provisions such as those directed at the trading activity of "any person" in "any security" whether or not registered on an exchange [*e. g.*, Section 10 (b)], and trading by "brokers" and "dealers" in securities "otherwise than on a national securities exchange" [*e. g.*, Section 15]. The principal securities markets are, of course, the national exchanges and the relatively systematized over-the-counter markets maintained by professional brokers and dealers. Hence a major portion of the statute is devoted to provisions which, in themselves and in conjunction with the rules promulgated thereunder, regulate these markets in considerable detail. It is obvious, however, that the provisions dealing with the exchanges and over-the-counter markets of brokers and dealers do not cover all the potentialities of fraud in the purchase or sale of securities. As we have already shown, outside the scope of these provisions are many transactions in non-registered securities not effected in the organized securities markets. They include, as here, the trading activities of corporate officers, directors, and controlling stockholders in the securities of their own corporations. It is relevant to note at this point that trading by corporate insiders is one of the relatively few practices *expressly* mentioned in the Section 2 preamble as giving rise to the need for the federal

statute. As previously stated, it was to encompass the large volume of trading activity not subject to other provisions of the 1934 Act that Congress enacted the comprehensive anti-fraud provisions of Section 10 (b).

That defendants' proffered construction of Section 2 cannot be correct is further emphasized by the broad definition which Congress gave to the term "security" in the very next section. As we have already mentioned, *supra*, p. 26, Section 3 (a) (10) defines the term "security" to include such varied types as "investment contracts" and "certificates of interest or participation in any profit sharing agreement"—securities which can hardly be conceived of as the subject of trading on an exchange or by securities brokers or dealers—certainly not the systematized trading defendants would require. *S. E. C.* v. *W. J. Howey Co.*, 328 U. S. 293 (1946),[23] to which we have referred, is only one of many cases pertaining to various schemes involving "sales" or "leases" of tangible property and comprehending collateral arrangements whereby the sellers generally retain control over the subject property, and their management or efforts are relied upon for the expectation of profits to the titular owners or lessees, and where the "sale" or "lease" in combination with such collateral

[23] The *Howey* case was concerned with the similar definition of a "security" in Section 2 (1) of the Securities Act of 1933, 15 U. S. C. § 77b (1). The Supreme Court rejected a similar defense that the statute was not intended to regulate the type of transaction involved, holding that this contention gave too narrow a construction of a piece of legislation which was intended to be broadly remedial in scope.

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arrangements has been held to constitute a "security" within the meaning of the federal securities laws.[24] This is another consideration to which Chief Judge Leahy referred in the *Speed* case in concluding that there was no merit to the proffered narrow construction of the 1934 Act (99 F. Supp., at 830–831).

(b) The legislative history

In an effort to overcome the plain language of Section 10 (b), and the above analysis which demonstrates that this language was intended to mean exactly what it says, defendants below, like the defendants in the other cases referred to, submitted various excerpts from the legislative history of the 1934 Act which, they contended, show that Congress

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[24] The following are illustrative:

Oil and gas leases with collateral representations that the seller would drill a well on the leased or nearby land which would prove the value of the leases: *S. E. C.* v. *C. M. Joiner Leasing Corp.*, 320 U. S. 344 (1943); *Atherton* v. *U. S.*, 128 F. 2d 463 (C. A. 9, 1942); *U. S.* v. *Earnhardt*, 153 F. 2d 472 (C. A. 7, 1946), *cert. denied*, 328 U. S. 858 (1946).

Tung tree acreage coupled with service contracts: *S. E. C.* v. *Tung Corporation of America*, 32 F. Supp. 371 (N. D. Ill. 1940); *S. E. C.* v. *Bailey*, 41 F. Supp. 647 (S. D. Fla. 1941).

Silver foxes coupled with a ranching agreement: *S. E. C.* v. *Payne*, 35 F. Supp. 873 (S. D. N. Y. 1940).

Conditional bills of sale for oyster half-shells to be planted on oyster bottom acreage: *S. E. C.* v. *Cultivated Oyster Farm Corp.*, CCH Fed. Sec. L. Rep., ¶ 90,121 (S. D. Fla., No. 350, March 22, 1939).

Undivided interests in specified fishing boats: *S. E. C.* v. *Pyne*, 33 F. Supp. 988 (D. Mass. 1940).

Whiskey warehouse receipts and bottling contracts: *S. E. C.* v. *Bourbon Sales Corp.*, 47 F. Supp. 70 (W. D. Ky. 1942), and *Penfield Co. of California* v. *S. E. C.*, 143 F. 2d 746 (C. A. 9, 1944), *cert. denied*, 323 U. S. 768 (1944).

really did not mean to subject "private transactions," like the instant one, to even the antifraud provisions of the Act. Again assuming *arguendo,* as defendants contend, that the legislative history may be referred to under such circumstances, we submit that the legislative history which defendants quoted in the court below does not show this and, actually, has no relevancy to the instant question. It deals with the regulation initially authorized by the *original* (*but since repealed*) provisions of Section 15, 48 Stat. 895, as respects the special markets "made or created" by brokers and dealers "for both the purchase and sale" of particular securities. This is a *specific type of trading activity* in the over-the-counter market, and should not be confused with the *scope* of the over-the-counter market itself. Confusion of the two concepts appears to be the basic ingredient of defendants' legislative history argument; for, without such confusion, there is not even a superficial semblance of merit to it.

We have already mentioned that, in 1934, Congress did not believe that it had sufficient information concerning the workings of the broker-dealer over-the-counter market to enact comprehensive statutory provisions with respect to the regulation of the various activities of brokers and dealers. Pending further study, which resulted in later amendments to the statute, it authorized the Commission to issue regulations which respect to the type of trading activity in the over-the-counter market which bore the closest resemblance to exchange trading and which, perhaps in a more limited fashion, presented comparable op-

portunities for manipulation. This authorization was contained in the original Section 15, with which the cited legislative history deals. In 1936 the original Section 15 was repealed, and comprehensive provisions of much broader scope were enacted respecting the activities of brokers and dealers. Section 15A, which rounded out the statutory program in this respect, was enacted in 1938. The present Section 15 encompasses all the trading activities of brokers and dealers. "Making or creating" a market in particular securities is not specifically referred to. Manipulative or deceptive practices in this or any other type of broker-dealer trading, however, are outlawed by special antifraud provisions of broad scope applicable to the nonexchange trading activities of brokers and dealers: Section 15 (c) (1).

The orginal Section 15 was a regulatory measure and not an antifraud provision as such. The catch-all provisions of Section 10 (b), it was probably felt at the time, would be a sufficient deterrent against fraudulent practices. For the information of the Court, we are setting forth below Section 15 as originally enacted. It should be observed that, in addition to authorizing the Commission to regulate transactions in two-way markets in particular securities which were "made or created" by particular brokers or dealers, and to require the registration of brokers and dealers making such markets, the Commission was authorized to require the registration of the securities for which such special markets were "made or created," and to make special provision with respect to securities which were listed or entitled

to unlisted trading privileges on any exchange, but which were not registered for exchange trading. The latter regulatory features, in particular, were the subject of the congressional debates which defendants cited. The original Section 15 read as follows:

> It shall be unlawful, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest and *to insure to investors protection comparable to that provided by and under authority of this title in the case of national securities exchanges,* (1) for any broker or dealer, singly or with any other persons or person, to make use of the mails or any means or instrumentality of interstate commerce for the purpose of *making or creating,* or enabling another to make or create, *a market, otherwise than a national securities exchange, for both the purchase and sale of any security* (other than an exempted security or commercial paper, bankers' acceptances, or commercial bills, or unregistered securities the market in which is predominantly intrastate and which have not previously been registered or listed), (2) or for any broker or dealer to use any facility of any such market. Such rules and regulations may provide for the *regulation of all transactions by brokers and dealers on any such market,* for the *registration* with the Commission *of dealers and/or brokers making or creating such a market,* and *for the registration of the securities for which they make or create a market* and may make *special provision with respect to securities* or specified classes thereof *listed, or entitled to unlisted trading privileges,*

> *upon any exchange* on the date of the enactment of this title, which securities are *not registered* under the provisions of section 12 of this title. [Emphasis supplied.]

If, in reading the excerpts from the legislative debates submitted by the defendants below, it is kept in mind (1) that the "over-the-counter" markets which the participants are talking about are the highly specialized markets for which extensive regulation was authorized by the original Section 15, (2) that the legislators were not discussing, and did not purport to discuss, the concept of the scope of the over-the-counter market generally, and (3) that the antifraud provisions of Section 10 (b) were not in controversy, it will be readily apparent that there is no merit to defendants' argument that their proffered views as to the limited scope of the "over-the-counter" market and of the statute itself are supported by the legislative history.

We shall discuss each of the excerpts from the legislative history which defendants submitted below. Because we prefer not to interrupt our argument with this lengthy specialized analysis and because this Court, like Judge Grim in the *Robinson* v. *Difford* case, may decide that reference to the legislative history is not warranted in light of the plain and unambiguous language of the statute itself, we have set forth this specialized discussion in Appendix A to this brief, pp. 78–85, *infra*.

Actually, the legislative history of the 1934 Act contains very little of specific applicability to Section 10 (b); and, so far as we know, there is nothing

therein which is of particular relevance to the instant controversy. Section 10 (b) was formulated late in the legislative process and, apparently, was not a controversial provision. The extensive remedial scope of the proposed Act as a whole, however, was frequently the subject of legislative comment; and the legislative history in this respect does indicate that members of Congress were aware of the fact that the proposed statute went far beyond the regulation of the organized securities markets. This is the legislative history to which Chief Judge Leahy referred in the *Speed* opinion (99 F. Supp., at 820, n. 12).[25] As we have stated before, the statute itself is sufficiently clear in this respect.

(c) The caption of Section 15

In the court below defendants argued, further, that Congress has defined the full scope of the "over-the-counter markets" in Section 15 of the Act, which bears that phrase as a section heading, and that

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[25] For example, the extensive remedial scope of the bill which became the Securities Exchange Act of 1934 was described by Senator Steiwer on the floor of the Senate as encompassing not merely the regulation of stock exchanges and securities brokers and dealers, but as containing provisions which were applicable also "to the public at large and to all who may trade in securities, to all owners and holders of stock, to corporations, to their officials * * *" (78 Cong. Rec. 8296).

Compare also the statement of Representative Lea during the course of the House debate (78 Cong. Rec. 7861):

"This bill, although it is called a bill to regulate national securities exchanges, is much broader in its practical operation. In fact, *the object of this measure is not merely to regulate exchanges—that is only incidental to its purpose. The real purpose of this regulatory measure is to protect the investors of the United States against fraud and imprudent investments* * * *." [Emphasis supplied.]

Section 10 (b) should be limited accordingly. The argument, of course, is grounded on the assumption that the phrase "over-the-counter markets" must be read into Section 10 (b)—an assumption which Judge Grim refused to make in the *Robinson* v. *Difford* case. Defendants, of course, have challenged the validity of Judge Grim's ruling; but, for reasons which we set forth below, we do not believe it matters much whether or not Judge Grim was correct in this respect.

Defendants have referred particularly to the anti-fraud provisions of Section 15 (c). Rather than attempt to paraphrase their argument, we quote from their principal brief below:

> It will thus be noted that when Congress was referring to a security dealt with on an over-the-counter market it merely used the words "any security" with the qualifying words "otherwise than on a national securities exchange." It seems obvious that since Congress, when deliberately defining a security dealt with in over-the-counter markets defined it in one place in the act as "any security otherwise than on a national securities exchange" that it meant precisely the same thing in Section 10 (b). Otherwise it would have included, after the words "or any security not so registered" in Section 10 (b), some language such as "including securities not traded in any over-the-counter market" (*Brief of defendants John R. Robinson et al.*, p. 23).

The logic in this argument, if there be any, is difficult to find. We believe that the argument is fallacious for either of the following reasons:

First: Section 15 (c) is expressly limited in application to transactions of a *"broker* or *dealer* * * * otherwise than on a national securities exchange." In contradistinction, Section 10 (b) applies to *"any person."* As we have already pointed out, Section 3 (a) (9) defines the term "person" very broadly, in contrast to limited definitions of the terms "broker" and "dealer" in Sections 3 (a) (4) and 3 (a) (5).[26] This alone provides a positive indication that, as respects nonexchange transactions, the coverage of Section 10 (b) was intended to go beyond the transactions dealt with in Section 15 (c). It should also be noted that the phrase "otherwise than on a national securities exchange" does not appear in Section 10 (b), which contains no limitations on where the fraudulent transaction must take place in order to come within the coverage of that section. Section 10 (b) simply authorizes the Commission to outlaw fraud in connection with the purchase or sale of "any security registered on a national securities exchange or any security not so registered." It should be further noted

[26] The 1934 Act is obviously different from the statutes involved in *U. S.* v. *Katz*, 271 U. S. 354 (1926), and *U. S.* v. *Jin Fuey Moy*, 241 U. S. 394 (1916), which defendants cited below as authorizing the court to define the meaning of the various terms used in Section 10 (b). The statutes in the cited cases did not define the term "person," and to have given the term its literal meaning would seriously have conflicted with the statutory schemes involved. In the instant case, the key terms—"person" and "security"—are specifically defined by the statute itself. Moreover, when they are given their express statutory definitions in construing Section 10 (b), that section fits well into a comprehensive statutory program. On the other hand, redefined in the manner suggested by the defendants, Section 10 (b) becomes largely a meaningless duplication of other statutory provisions.

that Section 15 (c) contains certain exemptions, whereas Section 10 (b) contains none. We believe it is clear from the foregoing that Congress deliberately excluded from this catch-all antifraud provision the limitations which defendants would now have this Court imply.

Second: Section 15 itself does not purport to define the scope of the over-the-counter markets, and such an intent cannot properly be derived from the heading of the section, whose only purpose is to provide a convenient reference guide. It should be remembered that the original Section 15 bore the same caption, and that its scope was much more limited than the present Section 15 (see pp. 46–48, *supra*). In fact, as we have already mentioned, in arguing that the Act should be limited in scope as respects nonexchange transactions to transactions in securities "regularly traded over-the-counter," defendants below illustrated their argument with quotations describing the specialized two-way over-the-counter markets encompassed by the original provisions of Section 15. Thus, on the one hand we find defendants arguing that a security must be traded in one of these specialized broker-dealers' markets in order that the Act be rendered applicable, and on the other hand arguing that the over-the-counter markets encompass the transactions covered by the present Section 15, which, of course, covers a much wider field. Section 15, today, applies to all nonexchange transactions by brokers or dealers, whether or not a market is being "made or created" in the particular security, or whether the broker or dealer is only buying or selling or trading

both ways. Section 15 is captioned "Over-the-Counter Markets" because it is the only section of the Act which deals exclusively, and today comprehensively, with the nonexchange activities of securities brokers and dealers [27]—activities which constitute by far the largest portion of the over-the-counter securities market and the only portion of that market subjected to detailed regulation by this statute. Other provisions, Sections 9, 10, and 16, 15 U. S. C. §§ 78i, 78j, 78p, in dealing with other matters, legislate also with respect to over-the-counter transactions; but in view of the scope of those sections a heading similar to that of Section 15 would be inappropriate. As we have said, the purpose of a section heading is merely to afford a convenient reference guide to the subject matter of the section. Accordingly, the caption is not determinative of the scope of the section, and certainly not (as here) the scope of another section to which it is not affixed. See *Brotherhood of R. R. Trainmen* v. *Baltimore & Ohio Ry.*, 331 U. S. 519, 528–529 (1947); *U. S.* v. *Tomicich,* 41 F. Supp. 33, 34 (E. D. Pa. 1941), *aff'd,* 126 F. 2d 1023 (C. A. 3, 1942); *S. E. C.* v. *Timetrust, Inc.,* 28 F. Supp. 34, 40–41 (N. D. Calif. 1939). Defendants' argument, taken to its logical end, would mean that the 1934 Act would have to be restricted in application to exchange transactions alone because of its over-all title "Securities Exchange Act"—a conclusion which hardly deserves further comment.

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[27] There is also, of course, Section 15A, which complements Section 15 and, as its heading indicates, deals with "over-the-counter brokers' and dealers' associations."

Defendants did not say so, but their argument below in this respect amounts to a contention that, as respects nonexchange transactions, Section 10 (b) has no independent significance but is apparently a useless duplication of Section 15 (c). We believe that we have shown that this is a great misconception of the statute.

(d) Strict construction of the 1934 Act as a criminal statute

In the court below defendants also argued that the 1934 Act is a criminal statute and its provisions must be strictly construed. They pointed to Section 32, 15 U. S. C. § 78ff, which provides penalties for *wilful* violations. Whether Section 10 (b) should be construed "strictly" or "liberally," we believe is of little importance; for we believe that the section, construed even "strictly," is too clear and unambiguous to warrant defendants' proffered limitation.

The identical argument was made without avail in the *Robinson* v. *Difford* case; and the same type of argument was expressly rejected by the Supreme Court in *S. E. C.* v. *C. M. Joiner Leasing Corp.,* 320 U. S. 344 (1943), a case involving the related 1933 Act. It may be observed at this point that, while there may be penal sanctions in appropriate cases for wilful violations of Rule X–10B–5, the federal securities laws, unlike the type of statute which is generally involved in the cases enunciating a rule of strict construction, are primarily remedial in purpose. In the *Joiner* case, Mr. Justice Jackson pointed to the differences in the views of state courts with respect to the question of "strict" or "liberal" construction of comparable pro-

visions in state "blue sky laws"—*i. e.,* provisions which may afford the basis of either civil relief or penal sanctions, or both—and observed that "the weight of authority is committed to a liberal construction" (320 U. S., at 353). He concluded, however, that there was no point in choosing between "liberal" or "strict" constructions, since the statutory provision in question had only one intended meaning, whether applied in a civil or criminal case. In other words, the difference in the nature of the proceedings could affect only the required degree of proof of a violation and similar questions calling for different answers in the two types of proceedings. The Securities Act was held applicable to the transactions in the *Joiner* case, because, as here, it was unnecessary to do anything "to the words of the Act [but] merely accept them" (320 U. S., at 355).[28]

[28] The authoritative value of a seemingly conflicting statement in the earlier Court of Appeals case of *Wright* v. *S. E. C.*, 112 F. 2d 89 (C. A. 2, 1940), which defendants cited, would appear to be nullified by the *Joiner* case. It is pertinent to note that even in the *Wright* case the court refused to apply criminal standards of proof in a proceeding under the 1934 Act to expel Wright from membership in designated national securities exchanges, which proceedings the court regarded as being "remedial" (112 F. 2d, at 94).

Rosenberg v. *Globe Aircraft Corp.*, 80 F. Supp. 123 (E. D. Pa. 1948), which defendants also cited, did refer to Section 10 (b) as a "criminal statute," not for the purpose of restricting in any manner the scope of that section, but merely to explain the doctrine of implied civil liability arising from the violation of a statute making certain acts unlawful for the protection of a class of which plaintiff is a member. It may be pertinent to observe that, in a dissenting opinion in *Slavin* v. *Germantown Fire Ins. Co.*, 174 F. 2d 799, 815 (1949) (the dissent being from the majority's holding that the principal defendant was absolved from a

(e) The Commission's failure to promulgate Rule X–10B–5 until 1942

In the court below defendants also argued that the failure of the Commission to promulgate Rule X–10B–5 until 1942—eight years after the passage of the Act—indicates that the Commission itself did not believe that it had the power to promulgate a rule as broad in scope as it now states Rule X–10B–5 to be. Defendants quoted from a similar statement in a case note in 64 Harv. L. Rev. 1018 (1951)[29] which commented adversely on the *Robinson* v. *Difford* decision. This argument did not originate there. It was also made in the briefs filed in the earlier cases by these and other defendants who similarly sought to avoid the impact of Rule X–10B–5. As it appears to us, the author of the note obtained it from the defendants' brief in the *Robinson* v. *Difford* case, whence he seems to have gotten most of his other arguments and citations. The basic fallacy in this argument is that, with respect to the instant matter, Rule X–10B–5 does not go beyond the statute itself.

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charge of fraud by a "last minute" disclosure), the Chief Judge of the Court of Appeals for the Third Circuit, the circuit in which the *Rosenberg* case was decided, took occasion to emphasize that "restrictive interpretation of the [1934] Act has been rejected," citing *Speed* v. *Transamerica Corp.*, 71 F. Supp. 457, 458 (D. Del. 1947), and *Charles Hughes & Co., Inc.*, v. *S. E. C.*, 139 F. 2d 434, 437 (C. A. 2, 1943).

For similar views, see *Norris & Hirshberg, Inc.* v. *S. E. C.*, 177 F. 2d 228, 233 (C. A. D. C. 1949), *Hughes* v. *S. E. C.*, 174 F. 2d 969, 975 (C. A. D. C. 1949), and *Fry* v. *Schumaker*, 83 F. Supp. 476, 478 (E. D. Pa. 1947).

[29] The title of this case note is "Securities Acts—Federal Securities Exchange Act—Fraudulent Purchase of Non-Registered Shares of Closely-Held Corporation is Violation of Section 10 (b)."

The basic controversy is not what Rule X–10B–5 means, but what Section 10 (b) itself means.[30]

As respects the authority granted by Section 10 (b), it was not, of course, limited in time. The Commission was entitled to move cautiously in determining the type of rule needed in light of its administrative experience and other relevant circumstances, including the existence of Section 17 (a) of the 1933 Act and the mail fraud statute (18 U. S. C., formerly § 388 now § 1341), and to proceed with care in drafting an effective rule. Relevant in this connection is the following statement by Mr. Justice Jackson in *U. S.* v. *Morton Salt Co.*, 338 U. S. 632, 647–648 (1950):

> The fact that powers long have been unexercised may well call for close scrutiny as to whether they exist; but if granted, they are not lost by being allowed to lie dormant, any more than non-existent powers can be prescripted by unchallenged exercise. We know that unquestioned powers are sometimes unexercised from lack of funds, motives of expediency, or the competition of more immediately important concerns. We find no basis for holding that any power ever granted the [Federal] Trade Commission has been forfeited by nonuser.

See also *Shawmut Ass'n* v. *S. E. C.*, 146 F. 2d 791 (C. A. 1, 1945), involving the Commission's power

[30] There is thus no similarity between this case and *Federal Power Commission* v. *Panhandle Eastern Pipeline Co.*, 337 U. S. 498 (1949) (cited both by the defendants and the author of the note), which did not involve any rule and in which the court was unable to find any statutory provision upon which to ground the power sought to be exercised by the Federal Power Commission.

to impose terms on the withdrawal of a security from listing with an exchange, where in rejecting a contention similar to that of the instant defendants the court stated (146 F. 2d, at 795):

> Where the question is whether an administrative agency has the power to issue a prospective regulation or order without any retrospective aspect, the sole test is what power was given by the Constitution and by Congress; there is no doctrine of estoppel by prior disclaimer or prior disuse.[31]

(f) Statements from other sources relied upon by defendants below

In addition to excerpts from the legislative history dealing with the original Section 15, defendants submitted quotations from other sources which, they claimed, supported their narrow view of the Act. Two student notes in the Harvard Law Review do so in part or in whole; the other quotations—excerpts from certain statements by Commission officials—do not. Accordingly, we confine our discussion at this point to the notes in the Harvard Law Review. For our comment on the other quotations, we refer the Court to Appendix B, *infra* pp. 86–88, should the Court desire to examine the statements involved.

We have already mentioned that the *Robinson* v. *Difford* case is adversely commented upon in 64 Harv. L. Rev. 1018. In the court below defendants quoted this case note in its entirety. We have also observed

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[31] See also *Fischman* v. *Raytheon Mfg. Co.*, 188 F. 2d 783 (C. A. 2, 1951), where the court, in considering other questions under Rule X–10B–5, took occasion to observe that the Rule "was validly promulgated by the S. E. C. pursuant to that Section" [i. e., § 10 (b)] (188 F. 2d, at 786).

that this student note appears to us to be but a summary of the various arguments in the defendants' briefs in the *Robinson* v. *Difford* case, documented largely with the same citations. As such, it closely parallels the briefs submitted by the defendants below. This note, accordingly, should be evaluated in the light of our analysis of defendants' arguments. We offer but one additional observation. The student writer states, among other things, that a defrauded minority stockholder has little need for the protection afforded by Rule X–10B–5, for "resort may still be had to state law, and most states impose the same obligation of fair dealing, at least on 'insiders,' " citing *Hotchkiss* v. *Fischer,* 136 Kan. 530, 16 P. 2d 531 (1932). We wish this were true; but unfortunately the need for Rule X–10B–5 stems principally from the fact that the common law of most states does not impose upon corporate insiders the same duty of fair dealing as does the federal statute, particularly as respects disclosure of material inside information. See *Fletcher on Corporations,* 1947 Rev. Vol. 3, §§ 1167–1174, and cases cited therein. The *Hotchkiss* case represents but a small minority view. *Id.,* § 1168.2, n. 78. The student note is inconsistent, in this respect, with two earlier notes—one in 59 Harv. L. Rev. 769, at 771 (1946),[32] and the other in 61 Harv. L. Rev. 858, at 865 (1948)[33]—in both of which it was recognized that the federal statute was designed to extend protection to

[32] Entitled "SEC Action Against Fraudulent Purchasers of Securities."

[33] Entitled "Implied Liability under the Securities Exchange Act."

investors where the common law of most states was inadequate.

The note in 64 Harvard Law Review is a sequel to the note in 61 Harvard Law Review. The suggestion that Section 2 might be resorted to as a basis for cutting down the broad coverage of Rule X–10B–5 to transactions by professional traders first appeared in the Volume 61 note, although there was very little elaboration on this theme at that time. The earlier Harvard note was cited by the defendants in both the *Robinson* v. *Difford* and *Speed* cases, but to no avail. The two notes have some additional inconsistencies. Thus, the writer of the Volume 61 note suggests that the statute is applicable to transactions by corporate insiders, such as those involved in the instant case. The author of the Volume 64 note, closely paralleling the theme of defendants' briefs, adopts a narrower view under which a corporate insider who victimizes a minority stockholder would suffer no liability by virtue of the federal statute unless the particular security had been "regularly traded" by brokers and dealers in the over-the-counter market. Again, the Volume 61 note states that "restrictive interpretation [of the federal statute] has * * * been rejected." This statement is inconsistent with the restrictive view adopted in the same note, as well as with the Volume 64 note, which makes no pretense at a liberal interpretation of the statute but affirmatively urges a restrictive construction. For a better reasoned and more comprehensive student article on Rule X–10B–5, see *The Prospects for Rule X–10B–5: An Emerging Remedy for Defrauded Investors,* 59 Yale L. J. 1120

(1950). The proffered limitation on the scope of the Act is rejected in the Yale article: *Id.*, p. 1140, n. 95.[34]

5. Significance of the construction proffered by defendants and adopted by the court below

We pass, finally, to a consideration of some of the implications of defendants' proffered construction which was adopted by the court below.

We have already pointed out that, contrary to the statutory definition of the term "security" in Section 3 (a) (10), defendants' construction would limit application of the Act to conventional types of securities which are susceptible of trading in the systematized securities markets. We have likewise shown—assuming that defendants would condition the applicability of the Act as respects a security not registered for trading on any exchange upon a showing that the security has been "regularly traded over-the-counter" in the sense that some broker or dealer is maintaining or has maintained a two-way market in that particular security—that their prof-

[34] It is pertinent to observe that the notes in Volumes 61 and 64 do not represent the first instances in which the student section of the Harvard Law Review has advocated a construction of the 1934 Act which would seriously limit its remedial scope. Thus, in 1946, the Volume 59 note took the position that there could be no right of private action for the violation of Rule X–10B–5 (p. 779). That view has since been unanimously rejected by the courts. See pp. 72–75, *infra*. Confronted with court rejection of this view, the later note in Volume 61 withdrew the Harvard Law Review's disapproval of such a civil remedy. As mentioned previously, the narrow view of the substantive scope of Section 10 (b) which the student section of the Harvard Law Review is presently advocating has also been rejected by the various courts which have ruled upon the matter, excepting the court below, and we believe it should also be rejected by this Court.

fered limitation also runs squarely counter to the express provisions of the present Section 15. That section, it should be recalled, in dealing with the activities of brokers and dealers in the over-the-counter market, contains no such restriction on its coverage. In fact, the limitation suggested by the defendants, if applied to Section 15, would in large measure nullify the effectiveness of that section.

Defendants' restrictive view also presents problems under other sections, for example Section 16 (b), 15 U. S. C. § 78p (b). That section requires holders of ten percent of any class of any equity security which is registered on a national securities exchange, and the officers and directors of the issuer of any such security, to disgorge to the corporation any profit realized by them from the purchase and sale, or sale and purchase, of *any* equity security of the issuer within a period of six months. While Section 16 (b) requires that there be at least one registered equity security, its provisions require the disgorgement of "short-swing" profits by such corporate insiders in any other equity security of the corporation, registered or unregistered, and irrespective of whether the security in question was ever traded, "regularly" or otherwise, by brokers or dealers. Defendants' theory as to the scope of the Act would require like restriction of the application of Section 16 (b) contrariwise to what seem to be its plain provisions.

Moreover, under defendants' view, a public offering of securities not registered for exchange trading, even were it nationwide, would not be subject to the anti-

fraud provisions of Rule X–10B–5 if the issuer saw to it that no securities brokers or dealers were involved, or at least that they did not make a two-way market in the particular securities. And this would be so despite the fact that the security would have to be registered under the 1933 Act before the offering could lawfully be made. Likewise, on the assumption that the securities were not yet the subject of a "two-way" broker-dealer's market, repurchases by corporate insiders from large numbers of public investors, under defendants' suggestion, would not be subject to the antifraud provisions of the 1934 Act. These results, of course, are absurd. They turn the statutory policy upside down; for in limited situations the federal securities laws provide just the reverse—*i. e.,* exemption from registration but not from the antifraud provisions. See pp. 25, 29, *supra.*

Defendants' view also would render the protective features of Section 10 (b) dependent on the fortuitous circumstance that somewhere a broker or dealer, no matter how distantly located, is making or had made a two-way market in the particular security. Not only is there lack of rational basis for conditioning the protection of the statute on so irrelevant a circumstance, but whether or not a broker or dealer is actually "making a market" in a particular security is a factual question which may often be difficult to answer even where he enters bid and asked quotations in the National Quotation Service daily sheets.[35]

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[35] See *In re M. S. Wien & Co.*, Securities Exchange Act Release No. 3855 (1946), for an example of the type of proof sometimes required to establish the fact that a broker or dealer had made a market in a particular security.

This is entirely apart from the fact that many brokers and dealers do not enter their quotations in the daily sheets or in any other publication, so that from a practical standpoint it may often be impossible to determine, under such a theory, whether or not a particular security holder is entitled to invoke the protection of the Act.

In sum, defendants' proffered construction would mean that a fraudulent transaction in a security which could not be shown to have been the subject of a two-way broker-dealer market—including a transaction by a corporate officer, director, or controlling stockholder involving the unfair use of inside information—could not be remedied under the federal Act, but under state law only, if at all, regardless of the interstate character of the transactions and the recognized insufficiency of many, if not most, local laws to deal effectively with such interstate transactions. It is obvious that such a view of the scope of the federal statute would "turn back the clock" a long way.

We respectfully submit that defendants' proffered limitation is contrary to the express language and clear purpose of Section 10 (b). Accordingly, we urge that it be rejected, and that the ruling of the court below accepting it be reversed.

II

The alleged uses of the mails to effect payment for and to obtain delivery of the securities purchased are sufficient under Rule X-10B-5

Paragraph V of the complaint alleges, albeit in general terms, that "the mails, telephone, telegraph

and other means and instruments of transportation in interstate commerce" were used in connection with the asserted fraud (Tr. 6). In paragraph XV there is a specific allegation that defendant John R. Robinson, on his own behalf and acting for the other defendants participating in the scheme at that time, used the mails to cause the First National Bank of Everett to instruct the National Bank of Commerce in Seattle, Washington, to transfer a credit of $49,000 to plaintiff's account in the latter bank in payment for her stock, and to forward her shares, theretofore held in escrow pursuant to an option agreement, to the Everett bank for delivery to Robinson (Tr. 17–18). Subsequently, in paragraph XVIII (d), plaintiff alleges further uses of the mails and instrumentalities of interstate commerce in connection with the later purchases from other minority stockholders (Tr. 21).

Whether or not paragraph V, had it stood alone, would have been objectionable because of its generality [36] is an academic question in this case because paragraphs XV and XVIII (d) do allege specific uses of the mails. The relevancy and sufficiency of the allegations of paragraph XVIII (d) involve mixed questions of fact and law relating to the nature and scope of the scheme to defraud, upon which we shall not comment. The allegations of paragraph XV, we believe, are clearly sufficient; for they specifically charge that the defendants caused the mails to be used to effect payment of the purchase price and to obtain delivery of plaintiff's shares. As we men-

[36] See, in this connection, *S. E. C.* v. *Timetrust, Inc.*, 28 F. Supp. 34 (N. D. Calif. 1939).

tioned earlier, the court below did not rule on this question.

In the court below defendants relied upon *Kemper* v. *Lohnes,* 173 F. 2d 44 (C. A. 7, 1949), to support their contention that the complaint was insufficient because it did not allege that any misrepresentations or misleading statements were transmitted through the mails or instruments of interstate commerce. The *Kemper* case, of course, involved not Rule X-10B–5 but the differently phrased judisdictional language of Section 12 (2) of the 1933 Act, 15 U. S. C. § 77l (2). As we show below, the peculiar wording of Section 12 (2) has divided the courts on the question whether, under that section, the mails or instruments of interstate commerce must be used to transmit the misrepresentations or halftruths complained of, or whether it is sufficient if the federal facilities are used at some point in the sale of the security. But there is no such division as respects Rule X-10B–5, or Section 17 (a) of the 1933 Act, upon which the Rule is patterned. The courts are agreed that, under Rule X-10B–5 and Section 17 (a) of the 1933 Act, it is sufficient if the mails or instruments of interstate commerce were used at some point in the sale of the security, irrespective of whether the misrepresentations or half-truths were communicated by either of these facilities. Although there are many court decisions under Rule X-10B–5 and Section 17 (a) of the 1933 Act, including rulings upholding the sufficiency of mailings to effect payment for, or delivery of, the security (see *infra* pp. 70–72), defendants cited none of them below. They argued, instead, that Section

12 (2) of the 1933 Act and Rule X-10B–5 employed almost identical language (which, of course, is not true), and relied on the controversial *Kemper* ruling under Section 12 (2) as authority for their contention under Rule X-10B–5.

Section 12 (2) deals with civil liabilities arising out of *sales* of securities involving untrue or misleading statements, and provides:

> Any person who—
>
> * * * * *
>
> (2) sells a security (whether or not exempted by the provisions of section 3, other than paragraph (2) of subsection (a) thereof), *by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements in the light of the circumstances under which they were made, not misleading* (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission
>
> shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security. [Emphasis supplied.]

The courts are split on the question whether the third clause ("by means of" etc.) modifies the first clause ("sells a security" etc.) or the second ("by the use of any means or instruments" etc.). Under the first view, Section 12 (2) is read as if the word "and" appeared between the second and third clauses, so that it would suffice if there were mailings in the sale of the security whether or not the mailings contained the particular misrepresentations or half-truths complained of. Under the second view, the third clause is treated as a modification or continuation of the second clause and, as such, requires that the jurisdictional facilities be employed to transmit the misrepresentations. The Court of Appeals for the Second Circuit has adopted the first, or broader, view: *Schillner* v. *H. Vaughan Clarke & Co.,* 134 F. 2d 875 (1943). The Court of Appeals for the Seventh Circuit has followed the second, or narrow, view: *Kemper* v. *Lohnes,* 173 F. 2d 44 (1949). There are other holdings and dicta.[37] The Commission itself has expressed the opinion that the *Schillner* view is correct, and that the *Kemper* view is incorrect. But the question as to the proper interpretation of Section 12 (2) of the 1933 Act is not before this Court.

[37] *Moore* v. *Gorman,* 75 F. Supp. 453 (S. D. N. Y. 1948), follows the *Schillner* view. *Siebenthaler* v. *Aircraft Accessories Corp.,* CCH Fed. Sec. L. Rep., ¶ 90, 112 (W. D. Mo. 1940), is in accord with the *Kemper* view. In addition, there are passing dicta in *Independence Shares Corp.* v. *Deckert,* 108 F. 2d 51 (C. A. 3, 1939), rev'd on other grounds, 311 U. S. 282 (1940), and *Murphy* v. *Cady,* 30 F. Supp. 466 (D. Me. 1939), favorable to the narrow view. As distinguished from the *Schillner* case, in which a well-reasoned opinion was handed down, none of the opinions in the cases favoring the narrow view contains any analysis of this interpretative problem.

The different language of Rule X–10B–5 does not give rise to such a controversy. Following the jurisdictional language of Section 10 (b) itself, Rule X–10B–5 provides:

> It shall be unlawful for any person, *directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails,* or of any facility of any national securities exchange,
>
> (1) *to employ any device, scheme, or artifice to defraud,*
>
> (2) etc. * * *
>
> (3) etc. * * *
>
> *in connection with* the purchase or sale of any security. [Emphasis supplied.]

Section 17 (a) of the 1933 Act, upon which the Rule is patterned, contains similar language. It seems clear from this language that it is sufficient if the mails or facilities of interstate commerce are used *in connection with* the fraudulent purchase or sale, and that it is not necessary, as defendants contended below, that the misleading statements be communicated by means of these instrumentalities. It should also be considered that Rule X–10B–5 applies, *inter alia,* to fraudulent securities transactions in which there may not be any affirmative misrepresentations, but where the fraud stems from active concealment of material facts or the non-disclosure of such facts where there is a legal duty to disclose. Defendants' view of the jurisdictional language of Rule X–10B–5 would have the effect of eliminating these common frauds from the coverage of the statute; for in such cases the court would be without jurisdiction

because of the absence of any misleading statements which could be communicated by mail or through interstate facilities. This further illustrates the basic invalidity of defendants' contention.

So far as we know, no court has ever imposed such a limitation on either Rule X-10B-5 or Section 17 (a) of the 1933 Act. On the contrary, mailings connected with a fraudulent securities transaction which do not involve the transmittal of any misrepresentations or statements of half-truths have consistently been upheld by the courts under these provisions, including the Court of Appeals for the Seventh Circuit, which in the *Kemper* case held to the contrary under Section 12 (2), and the Court of Appeals for the Third Circuit, which has expressed a contrary dictum under Section 12 (2).[38] Thus, mailings acknowledging part payment and transmitting deeds were held sufficient by the Court of Appeals for the Seventh Circuit in *U. S.* v. *Earnhardt,* 153 F. 2d 472 (1946), *cert. denied,* 328 U. S. 858 (1946). In *U. S.* v. *Monjar*, 47 F. Supp. 421 (D. Del. 1942), affirmed by the Court of Appeals for the Third Circuit, 147 F. 2d 916 (1943), *cert. denied,* 325 U. S. 859 (1945), mailings by defendants' agents to defendants containing reports of the success of meetings held to obtain money from victims, and remitting cash statements and bank drafts, were also held sufficient. In *Slavin* v. *Germantown Fire Ins. Co.*, 174 F. 2d 799 (C. A. 3, 1949), the principal defendant had purchased shares of a new issue of stock sold by an insurance company which had just been converted from a mutual to a

[38] See n. 37, *supra.*

stock company. It was alleged that, by concealing material facts from the board of directors of the insurance company as to the probable extent of policy holder participation in the purchase of these new shares, this defendant had been in large measure responsible for the company's action in converting to a corporation from which he ultimately benefited. He never used the mails himself; but the insurance company, to effectuate the conversion, did use the mails to send out notices of a stockholders' meeting held to approve the conversion plan, and to send out proxy forms. Subsequently, prospectuses were distributed by the company through the mails. Subscription warrants were also sent through the mails. The District Court dismissed a complaint under Rule X–10B–5 for lack of sufficient use of the mails to provide jurisdiction. 74 F. Supp. 876 (E. D. Pa. 1947). On appeal the defendant conceded that there was jurisdiction, but argued that no fraud had been shown. In a split decision, the Court of Appeals for the Third Circuit held that a "last minute" disclosure by this defendant absolved him from the charge of fraud. The mailing question is discussed more fully in the dissenting opinion of the chief judge. 174 F. 2d, at 810, 814.

Other examples of mailings which have been held sufficient, including mailings of the type alleged in the instant complaint, are as follows: delivery by mail of a stock certificate after the contract of sale was concluded orally and the stock paid for;[39] mail-

[39] *S. E. C.* v. *Wimer*, 75 F. Supp. 955 (W. D. Pa. 1948). See also *U. S.* v. *Ryan*, 2 S. E. C. Jud. Dec. 423 (S. D. Fla. 1941) (delivery of whiskey warehouse receipts pursuant to executory contract).

ings of warranty deeds between defendants, and to the county clerk for recording and subsequent delivery to investors;[40] mailings of confirmation slips;[41] a mailing requesting delivery of securities to a third person and a reply by mail stating that this had been done;[42] and a mailing by a bank to effect collection of a check representing the receipts of defendant's fraud.[43] As a court in this circuit has stated, "the character of the matter sent by mail is immaterial" where the mailing is connected with the fraudulent sale.[44]

III

A private civil action may be maintained for the violation of Rule X–10B–5

In the court below defendants also argued that, since no private action is expressly provided by the 1934 Act for a violation of a rule under Section 10 (b), a violation of Rule X–10B–5 can give rise only to action by the government, and cannot afford a private person who has been injured by the violation the right to maintain an action for damages or other relief.

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[40] *Mansfield* v. *U. S.*, 155 F. 2d 952 (C. A. 5, 1946), *cert. denied*, 329 U. S. 792 (1946).

[41] *U. S.* v. *Kopald-Quinn & Co.*, 1 S. E. C. Jud. Dec. 371 (N. D. Ga. 1937), *aff'd*, 101 F. 2d 628 (C. A. 5, 1939), *cert. denied*, 307 U. S. 628 (1939); *Kaufman* v. *U. S.*, 163 F. 2d 404 (C. A. 6, 1947), *cert. denied*, 333 U. S. 857 (1948); *U. S.* v. *Guaranty Underwriters, Inc.*, S. D. Fla., No. 7155–J–Cr., Oct. 3, 1944, 3 S. E. C. Jud. Dec. 240.

[42] *Bogy* v. *U. S.*, 96 F. 2d 734 (C. A. 6, 1938), *cert. denied*, 305 U. S. 608 (1938).

[43] *U. S.* v. *Vidaver*, 73 F. Supp. 382 (E. D. Va. 1947).

[44] *S. E. C.* v. *Timetrust, Inc.*, 28 F. Supp. 34, 42 (N. D. Calif. 1939).

This contention was properly rejected by the court below (Tr. 41).

Considering the fact that the right to maintain a private action for the violation of Rule X–10B–5 has been unanimously upheld by a great number of courts, and that we are not certain at this time as to the extent to which it will be an issue in this appeal, we do not propose to reargue the question in detail in this brief. Should appellees present an argument on this question which would warrant additional comment on our part, we shall do so in a reply brief.

The implied right of private action under Rule X–10B–5 has been predicated primarily upon basic tort law that a person who has been injured by another's violation of a statute intended for his protection, or for the protection of a class of which he is a member, may maintain a civil action for private relief, provided that the statute itself does not withhold such relief or make other provisions for private relief inconsistent with the application of this tort doctrine. *Restatement of Torts,* vol. 2, § 286; *Kardon* v. *National Gypsum Co.,* 69 F. Supp. 512, 513–514 (E. D. Pa. 1946).[45] There is, in addition, Section 29 (b) of the 1934 Act, 15 U. S. C. § 78cc (b), which

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[45] The earlier case of *Baird* v. *Franklin*, 141 F. 2d 238 (1944), *cert. denied*, 323 U. S. 737 (1944), involving Section 6 (b) of the Act, 15 U. S. C. § 78f (b), provided strong authority for the application of this doctrine. In that case the Court of Appeals for the Second Circuit agreed that a private action could be maintained for violation of Section 6 (b), for which there is similarly no express provision authorizing a private action. Plaintiffs lost the *Baird* case only because they had failed to sustain the burden of proving their damages. See, particularly, the opinion of Judge Clark, 141 F. 2d, at 245.

provides that any contract made in violation of the Act shall be void as respects the rights of the violator. Because of the limited scope of the express civil liabilities provisions of the 1934 Act,[46] and the provisions of Section 29 (b) (particularly an amendment thereto in 1938) which indicate that Congress assumed that private actions could be maintained for the violation of many of the provisions of the 1934 Act which do not expressly authorize private recovery,[47]

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[46] Private actions are expressly authorized by Sections 9 (e), 16 (b), and 18 (a) of the 1934 Act, 15 U. S. C. §§ 78i (e), 78p (b), 78r (a). These provisions, however, deal with only a small part of the field covered by this Act. The substantive right of action authorized by each of these sections, to a large extent, is one unknown to the common law; and each contains special procedural provisions, including a relatively short statute of limitations. Congress may have legislated in detail with respect to these sections for the purpose of imposing circumscriptions which it did not want imposed on other private actions under the statute. See *Baird* v. *Franklin*, 141 F. 2d 238, at 245 (C. A. 2, 1944), *cert. denied*, 323 U. S. 737 (1944). Under the circumstances, the maxim "expressio unius est exclusio alterius" (upon which defendants relied in the court below) has been subordinated to what has been regarded as the statutory policy not to obstruct application of the basic tort doctrine. See the *Kardon* case, 69 F. Supp., at 514, and the *Baird* case, 141 F. 2d, at 245. Supreme Court authority for so subordinating the quoted maxim is found in *S. E. C.* v. *C. M. Joiner Leasing Corp.*, 320 U. S. 344, at 350 (1943).

[47] The 1938 amendment to Section 29 (b), 52 Stat. 1076, provided, *inter alia*, a short statute of limitations with respect to actions for the violation of Commission rules under Section 15 (c) (1), which, like Section 10 (b), does not expressly authorize a private action. This has been regarded as giving additional support for the right to maintain an action for the violation of Rule X–10B–5; for, by implication, the amendment suggests that Congress always assumed the availability of private actions under Section 15 (c) (1) and similar provisions such as Section 10 (b).

the courts have had no difficulty in upholding the right of a defrauded seller of securities to maintain a private action for the violation of Rule X-10B-5. For a comprehensive discussion, see the *Kardon* opinion, *supra,* and the comment in 59 Yale L. J. 1120, at 1133 *et seq.,* to which we have previously referred.

We set forth below some of the many cases in which the right to such private action has been upheld or recognized:

Fischman v. *Raytheon Mfg. Co.,* 188 F. 2d 783 (C. A. 2, 1951);

Slavin v. *Germantown Fire Ins. Co.,* 174 F. 2d 799 (C. A. 3, 1949);

Kardon v. *National Gypsum Co.,* 69 F. Supp. 512 (E. D. Pa. 1946);

Robinson v. *Difford,* 92 F. Supp. 145 (E. D. Pa. 1950);

Speed v. *Transamerica Corp.,* 71 F. Supp. 457 (D. Del. 1947), and 99 F. Supp. 808 (D. Del. 1951);

Osborne v. *Mallory,* 86 F. Supp. 869 (S. D. N. Y. 1949);

Hawkins v. *Merrill Lynch, Pierce, Fenner & Beane,* 85 F. Supp. 104 (W. D. Ark. 1949);

Fry v. *Schumaker,* 83 F. Supp. 476 (E. D. Pa. 1947).

Not only has no court ever denied the right of private action for the violation of Rule X-10B-5 but, on the contrary, the underlying rationale has been applied to permit private lawsuits for violations of other provisions of the federal securities laws which similarly contain no express authorization for such actions: see, *e. g., Remar* v. *Clayton Securities Corp.,* 81 F. Supp. 1014 (D. Mass. 1949), *Appel* v. *Levine,*

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85 F. Supp. 240 (S. D. N. Y. 1948), and *O'Connell* v. *Mallory,* CCH Fed. Sec. L. Rep. ¶ 90,445 (S. D. N. Y. 1949) [Regulations T and U under Section 7 of Securities Exchange Act of 1934]; *Osborne* v. *Mallory,* 86 F. Supp. 869 (S. D. N. Y. 1949) [Section 17 (a) of the 1933 Act; Section 15 (c) (1) of the 1934 Act and Rule X–15C1–2 thereunder]; *Hawkins* v. *Merrill Lynch, Pierce, Fenner & Beane,* 85 F. Supp. 104 (W. D. Ark. 1949) [Sections 11 (d) and 17 (a) of the 1934 Act, and Rule X–17A–5 thereunder]; *Fischman* v. *Raytheon Mfg. Co. et al.,* 188 F. 2d 783 (C. A. 2, 1951) [Section 17 (a) of the 1933 Act, dictum].[48]

IV

The applicable statute of limitations for a Rule X–10B–5 action for damages is that of the state of the forum

Defendants' contention that the action is barred by the statute of limitations was also rejected by the court below (Tr. 41). We express no opinion on the propriety of that ruling; for the question involves the construction of state law with respect to which we claim no expertise.

We confine ourselves merely to the observation that there is no federal statute of limitations in the 1934 Act, or elsewhere, applicable to a private action for damages based on a violation of Rule X–10B–5, and

[48] In so referring to the *Osborne* and *Fischman* cases in this string of citations which we have set forth for the information of the Court, we do not wish to be understood as taking the view that the same rationale can properly be applied so as to provide an implied private right of action for the violation of Section 17 (a) of the 1933 Act. This question is not involved here, and we express no opinion on it.

that the federal rule in such a case requires the court to apply the statute of limitations of the state of the forum. *Fischman* v. *Raytheon Mfg. Co.,* 188 F. 2d 783, 787 (C. A. 2, 1951); *Osborne* v. *Mallory,* 86 F. Supp. 869, 879 (S. D. N. Y. 1949). See also *Cope* v. *Anderson,* 331 U. S. 461, 463 (1947); *Burnham Chemical Co.* v. *Borax,* 170 F. 2d 569, 576 (C. A. 9, 1948); *Caldwell* v. *Alabama Dry Dock and Shipbuilding Co.,* 161 F. 2d 83, 85 (C. A. 5, 1947), *cert. denied,* 332 U. S. 759 (1947); *Williamson* v. *Columbia Gas & Electric Corp.,* 110 F. 2d 15, 16 (C. A. 3, 1939), *cert. denied,* 310 U. S. 639 (1940). The appropriate reference, in the instant case, is the local law of the State of Washington.

CONCLUSION

Assuming that the action is not barred by the applicable statute of limitations, we believe that the judgment below dismissing the action should be reversed.

Respectfully submitted.

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APPENDIX A

ANALYSIS OF EXCERPTS FROM LEGISLATIVE HISTORY RELIED UPON BY DEFENDANTS BELOW

For our discussion of the original Section 15 of the Act, with which the following excerpts are concerned, we refer the Court back to pp. 44–49 in the main portion of this brief.

(1) *Statement by Representative Rayburn* (78 Cong. Rec. 7419):

> In Section 3 of the Bill, we set forth the definitions; and I shall insert in the Record at this point some further definitions of terms which may be used in connection with the discussions of the bill * * *
>
> * * * * *
>
> "Over-the-counter market," as used in this bill, refers to *a market maintained* off a regular exchange *by one or more dealers or brokers. The market must be maintained both for the purchase and sale of the securities in question.* A dealer or broker who merely undertakes a request to find a purchaser for a person who wants to sell or to find a seller for a person who wants to buy, would not usually be considered to be *creating a market. But the dealer who normally is willing to quote "a market," i. e., both the price at which he will buy and the price at which he will sell, is creating an over-the-counter market.* [Emphasis ours.]

Comment: Mr. Rayburn was discussing only the scope of the regulation provided by the original (but since repealed) provisions of Section 15 of the Act with respect to the two-way over-the-counter markets in particular securities made or created by brokers

and dealers. He did not purport to discuss the limitations of the bill as a whole. In the quoted excerpt, Mr. Rayburn emphasized that creating an over-the-counter market in a particular security, within the meaning of the regulation authorized by the original Section 15, required two-way quotations—*i. e.,* quotations of both bid and asked prices for the security in question. As we have already pointed out, pp. 45–48, *supra,* the Act as originally passed did not authorize regulation of the nonexchange activities of brokers and dealers generally, but only of the special two-way over-the-counter markets in particular securities which they made or created. The catch-all provisions of Section 10 (b) were relied upon as a general deterrent against fraud.

(2) *Statements in Senate and House Committee Reports:*

(a) *Senate Statement* (Sen. Rep. No. 792, 73d Cong., 2d Sess., p. 6):

> In addition to the organized security markets there exist in financial centers unorganized "over-the-counter" markets where *securities are bought and sold in large volume.* Many of these securities are of a conservative character, such as Government, State and Municipal bonds which are exempted from the provisions of the bill; but others are more speculative in nature and are *subject to the abuses of manipulation.* For example, the Committee has heard of extensive manipulation in certain New York bank stocks after their withdrawal from the New York Stock Exchange and while they were being sold "over-the-counter". These manipulations resulted in tremendous losses to the investing public, and in enormous profits to insiders. *It has been deemed advisable to authorize the Commission to subject such activities to regulation similar to that prescribed for transactions on organized exchanges.* This

> power is vitally necessary to forestall widespread evasion of stock exchange regulation by the withdrawal of securities from listing on the exchanges, and by transferring trading therein to *"over-the-counter" markets where manipulative evils could continue to flourish,* unchecked by any regulatory authority. Since the necessity for regulation of "over-the-counter" markets will depend largely on the extent to which activities prohibited on exchanges are transferred to such markets, *provision for their regulation* has been made as flexible as possible. [Emphasis ours.]

Comment: This paragraph appears in a section of the Senate report dealing with "Registration of Exchanges." It pointed to the need for supplementing the regulatory provisions of the bill respecting exchanges with provisions for the regulation of comparable "over-the-counter" markets in particular securities which brokers and dealers may create or make, and where manipulation may also occur.[1]

(b) *House Statement* (H. R. Rep. No. 1383, 73d Cong., 2d Sess., pp. 15–16):

> The Committee has been convinced that effective regulation of the exchanges requires as a corollary a measure of control over the "over-the-counter" markets. The problem is clearly put in the recent report of the Twentieth Century Fund on "stock market control":
>
> "The benefits that would accrue as the result of raising the standards of security exchanges might be nullified if the over-the-counter markets were left unregulated and uncontrolled. They are of vast proportions and they would serve as a refuge for any business that might

[1] For an example of manipulation in an over-the-counter market which a broker-dealer had made for one security, see *In re M. S. Wien & Co.*, Securities Exchange Act of 1934, Release No. 3855 (1946).

> seek to escape the discipline of the exchanges; and the more exacting that discipline, the greater the temptation to escape from it. Over-the-counter markets offer facilities that are useful under certain conditions, but they should not be permitted to expand beyond their proper sphere and compete with the exchanges for business that, from the view of the public interest, should be confined to the organized markets. This constitutes the sanctions for federal regulation of over-the-counter dealers and brokers. To leave the over-the-counter markets out of a regulatory system would be to destroy the effects of regulating the organized exchanges."

Comment: The above paragraph, including the quotation from the Twentieth Century Fund publication, appears in a section of the House report dealing with "Control of the Exchanges and Over-the-Counter Markets." The subject of discussion was the same as that involved in the above excerpt from the Senate report, namely, the need for supplementing regulation of the stock exchanges with regulation of the somewhat comparable nonexchange markets made or created by brokers and dealers. The scope of other provisions, such as the general antifraud section in question, was not involved.

(3) *Statements of Representative Maloney:*

> If one wants to put effective restraints upon excessive speculation on the exchanges, it is obviously necessary to guard against the same sort of excessive speculation on the unregulated markets. But those who tell you that the over-the-counter provisions of the bill will interfere directly with the small industrial concern are either wilfully misleading you or are ignorant of what the bill really does. The control of the Commission with respect to the over-the-counter markets may be exercised *only over*

> *dealers or brokers who maintain a public market.* The Commission has no power to cause any corporation to file any statement or to subject itself in any way to regulation. *Even the dealer or broker is not subject to control if he does no more than to try to find a buyer for a person who wants to sell some shares or to find a seller for a person who wants to buy some shares.* A dealer or broker *creates or maintains* an over-the-counter market as it is defined in the bill *only if he stands ready both to buy and sell;* that is, if he stands ready to quote you a price at which he will buy your shares as well as a price at which he will sell your shares (78 Cong. Rec. 7868). [Emphasis ours.]
>
> This bill is primarily designed to prevent a manipulation of securities—the kind of manipulation that threatened the lives of the insurance companies of America, and thereby the humble estates men endeavored to create by the sweat of the brow and real self sacrifice. It would remove a chance at manipulation that not only threatened the banking system of the country but actually left many banks broken wreckage upon the rocks. It would forever forbid a manipulation that boiled a market to the point where it attracted credit away from the proper channels of industry into uncertain paths of speculation (*Id.,* p. 7869).

Comment: As is obvious from the text, Mr. Maloney, like Mr. Rayburn, was discussing the scope of the regulation authorized by the original Section 15, and the "control" which the bill proposed to give the Commission with respect to over-the-counter markets in securities made or created by brokers and dealers. Again, the general anti-fraud provisions of Section 10 (b) were not involved.

(4) *Statement of Representative Mapes* (78 Cong. Rec. 7711):

> And the only provision in the bill that relates to small or local corporations in that respect, as I understand it, is the one in the over-the-counter market section, which gives the * * * Commission authority in its regulations of dealers and brokers in the over-the-counter markets to require that such dealers and brokers cease to handle the securities of any corporation unless they are listed with them, but in no case is a corporation required to so list unless it see fit to do so.

Comment: This statement was in answer to a question by Representative Merritt as to whether the bill would give the Commission power to compel every corporation to list for trading. Mr. Mapes referred to the proposed regulation of the markets in particular securities created by brokers and dealers, which we have already discussed, and expressed the view that, so far as the problem of listing was concerned, the small local corporations mentioned by Mr. Merritt could be affected only by these provisions. The statement has no relevancy to the instant question.

(5) *Statement of Senator Steiwer* (78 Cong. Rec. 8189):

> I merely want to make a suggestion. It is not appropriate, in order to calm the fears of those who now raise the question as to the inclusion of small intrastate corporations, to say to them that the bill by its terms does not and cannot reach such corporations. In the first place, this bill deals with stock exchanges, and with the regulation of the over-the-counter market. The very least corporation, if it should seek to list its stock upon the stock exchange, would be obliged to comply with this proposed law. That might be so even though it was an intrastate institution, because the stock exchange may be engaged in an inter-

> state business and the intrastate operation comes in quite incidentally.
>
> I think, therefore, the very least corporation might subject itself to regulation under this proposed act if it should seek to sell its securities over-the-counter. But unless the stock crosses the threshold of one of these institutions or the other, it is not affected by the proposed law, whether it be a big institution or a little institution.

Comment: Senator Steiwer's observation that small intrastate corporations would not be affected by the listing requirements of the proposed Act unless they sold on an exchange or "over-the-counter" obviously had reference in the latter regard to the proposed provisions of the original Section 15, which, as we have already pointed out, empowered the Commission to promulgate listing requirements for securities traded on the over-the-counter markets made or created by brokers or dealers.

(6) *Statement by Representative Rayburn* (78 Cong. Rec. 7701):

> The Commission also has power to *regulate* the over-the-counter markets, but in so doing they can only regulate the brokers or dealers who *create* a public market for *both the purchase and sale* of such securities, and cannot compel corporations not interested in having a public market for their shares to file any statements or submit to any regulation. [Emphasis ours.]

Comment: Again Mr. Rayburn was discussing the scope of the regulatory provisions of the original Section 15, not the scope of the Act as a whole.

(7) *Colloquy between Senators Dill and Barkley* (78 Cong. Rec. 8190):

> Mr. Dill. The Senator is a lawyer and he knows that lawyers can make words mean al-

> most anything. If it is the intent of this bill not to include corporations whose stock is not so registered on an exchange or not dealt in over the counter, of course, if that is the intent, he, as a legislator, only has to write it in the bill so that there cannot be any question.
>
> Mr. BARKLEY. Section 2 of the bill itself says that only those are included in the proposed law. Why should any one imagine that some-or else will be included in it?

Comment: Senator Dill had inquired whether it was true that, under the proposed statute, "corporations of all kinds with any established interstate business will be required to make reports to the Commission" (*ibid.*). Senator Barkley replied that, if the corporation's securities were not sold on an exchange or in the over-the-counter markets (*i. e.,* those made by brokers and dealers and subjected to Commission regulation under the proposed Section 15), no reports could be required. Senator Dill thereupon suggested a specific amendment to that effect, in response to which Senator Barkley made the above quoted statement to the effect that the bill already made it clear who would be affected by the regulatory provisions in question. Senator Byrnes thereupon entered the discussion to explain the scope of the proposed Section 15 and to state that he had no objection to a clarifying amendment if carefully drawn to exclude purely intrastate sales (*ibid.*).

APPENDIX B

COMMENT UPON STATEMENTS BY COMMISSION OFFICIALS QUOTED BY DEFENDANTS BELOW

Defendants quoted from (1) an address in 1944 by the later Edward H. Cashion when he was Counsel to the Commission's Corporation Finance Division, (2) a casebook prepared in 1947 by Louis Loss, the Commission's present Associate General Counsel, who is representing the Commission in the instant case, and (3) a statement in the Commission's 14th Annual Report.

(1) *Excerpt from Mr. Cashion's speech:*

> The Securities and Exchange Act of 1934 and its subsequent amendments were designed to regulate trading in securities—the purchase and sale of securities—on national securities exchanges and in over-the-counter markets, and to regulate brokers and dealers. The act and its amendments were designed to strengthen the fraud prevention and disclosure provisions of the prior act. (Cashion, address entitled, "*Fraud on the Seller of Securities,*" published in Proceedings of Twenty-Seventh Annual Convention of National Association of Securities Commissioners (1944), 109, at 110.)

Comment: We do not understand what succor defendants derive from this statement. In the very same paragraph immediately following the quoted excerpt, Mr. Cashion went on to say—

> One step in that direction was the promulgation of a Rule by the Commission, now known as Rule X–15C1–2, adopted pursuant to Section 15 (c) of the 1934 Act. That Rule prohibits fraud by brokers and dealers in either the sale

> or purchase of securities. Another loophole, however, was still to be closed in the protections administered by the Commission. The step to close that loophole was taken in May 1942 when the Commission, acting pursuant to Sections 10 (b) and 23 (a) of the Act, adopted Rule X–10B–5. This Rule embodies the broad anti-fraud provisions of Section 17 (a) of the 1933 Act, and specifically prohibits fraud by *any person* in connection with the *purchase or sale* of securities. [*Ibid.* Emphasis that of Mr. Cashion.]

Earlier in his address, Mr. Cashion pointed out that—

> * * * the Securities Act of 1933, was designed to bring about adequate disclosure of the nature of securities to be offered for sale to the public and to prevent fraud in their distribution or sale. *Although certain securities and certain security transactions are exempted from the registration provisions of that Act, there are no exemptions from its anti-fraud section, Section 17 (a).* [*Ibid.* Emphasis ours.]

We have already pointed out that the pattern of the Securities Exchange Act of 1934 is similar. See pp. 25, 29, *supra*.

(2) *Excerpt from the Loss casebook:*

> The over-the-counter markets, in general, are the unorganized markets in which there are meetings of individual supply and demand as contrasted with the organized markets or exchanges where there are meetings of collective supply and demand. Over-the-counter transactions take place in the offices of brokers and dealers and do not involve the trading facilities of an exchange. (Loss, *"Cases and Materials on SEC Aspects of Corporate Finance,"* 1947, p. 119.)

Comment: This is not Loss's statement, but a paragraph from this Commission's "Report on the Feasibility and Advisability of the Complete Segregation of the Functions of Dealer and Broker" (1936), quoted in Loss's chapter on "Regulation of the Over-the-Counter Market and Investment Advisers." As indicated by its title, the report deals with a specific regulatory problem respecting brokers and dealers. The quoted paragraph, taken in the context of the paragraphs which follow in the report, purports merely to distinguish the broker-dealer over-the-counter market from the exchange market, and does not purport to describe the full scope of the over-the-counter market. On the contrary, the recently published treatise by Loss takes the same position that is maintained in this brief. See Loss, *Securities Regulation* (1951), pp. 709, 840–41.

(3) *Excerpt from the Commission's 14th Annual Report* (1948), p. 24:

> The Securities Exchange Act of 1934 is designed to eliminate fraud, manipulation, and other abuses in the trading of securities both on the organized exchanges and in the over-the-counter markets, which together constitute the Nation's facilities for trading in securities; to make available to the public information regarding the condition of corporations whose securities are listed on any national securities exchange; and to regulate the use of the Nation's credit in securities trading.

Comment: Again, we have been unable to discern anything in this generalized statement which lends any support to the defendants. On the contrary, the quoted excerpt only serves to emphasize the broad remedial scope of the present statute.

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